(3)

No. 84-1362

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

PUBLIC SERVICE COMMISSION OF MARYLAND,
Petitioner,

v.

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF MARYLAND,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

JOINT APPENDIX

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PETITION FOR WRIT OF CERTIORARI FILED FEBRUARY 15, 1985
CERTIORARI GRANTED JUNE 24, 1985

The Daily Record Co., Baltimore, MD 21202

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UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

CALENDARED

Docket No. 83-1403

Friday December 9, 1983

Origin: DMD at Baltimore; DC Docket No.: C/A N-83-855; DC Judge: Edward S. Northrop; Filed in DC:

03/21/83; DC Judgment: 04/06/83; NOA Filed: 04/14/83; Amended NOA: 05/03/83; Docketed 05/03/83; Fee Paid ☒; Case Type: CV.PRI; Rule 17: Complete; Caption ☒ Complete.

Title of Case:

The Chesapeake and Potomac Telephone
Company of Maryland, Appellee,

v.

Public Service Commission of Maryland,
Frank O. Heintz, Chairman,
William A. Badger, Commissioner,
Lilo K. Schifter, Commissioner,
Wayne B. Hamilton, Commissioner,
Haskell N. Arnold, Commissioner, Appellants.

and

Ronald Hawkins, Executive Director and Maryland
Office of People's Counsel, Defendants.

Federal Communications Commission, Amicus Curiae.

Appearances:

Appellant/Petitioner:

05/12/83, Kirk J. Emge, 231 East Baltimore Street, Baltimore, MD 21202, (301) 659-6012.

Appellee/Respondent:

05/13/83, J. William Sarver, One East Pratt Street, Baltimore, MD 21202, (301) 393-7725 and 05/13/83, Mark J. Mathis, Michael J. Morrissey, D. Michael Stroud, 1710 H Street, NW, Washington, DC 20006, (202) 392-5121.

RECORD OF APPEAL

Docket No. 83-1403

Filed 6/29/83

Pleadings: 1 ((Vol. I) — Transcript: 1 (Vol. II)

Withdrawn: 2 Volumes (ska) 7/25/83, Kay Craig,
Returned 7/27/83.

Brief and Appendix:

8/5/83—6 copies of Joint Appendix filed CS-js.

8/5/83—12 copies of Appellant's Brief filed CS-js.

9/8/83—12 copies of Appellee's Brief filed CS-js.

9/22/83—12 copies of Appellant's Reply Brief filed HD-js.

Summary of Events:

Argument: 12-9-83 wc; Panel: DR FDM (JHM); Opinion: Nov. 20, 1984; Judgment: Nov. 20, 1984; Disposition: aff P jrg; Mandate Issued: 12-11-84 lgs; Record Returned: 12-11-84 lgs; Certiorari: 2/15/85 84-1362; Granted 6/24/85 lgs.

Continuation of Appearances:

Appellee: 5/31/83, Lewis T. Booker, Virginia W. Powell, Hunton & Williams, P.O. Box 1535, Richmond, VA 23212, (804) 788-8200.

Appellant: 07-18-83, Sandra L. Hall, Staff Attorney, Public Service Commission, 231 E. Baltimore Street, Baltimore, MD 21202, (301) 659-6000.

Honorable James H. Michael, Jr., U.S District Judge, P.O. Box 671, Charlottesville, VA 22902.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 83-1403

DOCKET ENTRIES

05/03/83—Case docketed. Awaiting ROA. tcb.

05/12/83—DISCLOSURE STMNT, As, N, filed. tcb.

05/13/83—DISCLOSURE STMNT, E, Y, filed. tcb.

06/30/83—BRIEFING ORDER filed, A due 08/09/83. Tentative calendar October/November 1983. tcb.

07/14/83—DESIGNATION—As, parts to be included in joint appendix, and statement of issues on appeal, filed. tcb.

07/18/83—DESIGNATION—E, additional parts to be included in joint appendix, filed. tcb.

12/2/83—MOTION (L-8) of Federal Communications Commission for leave to file statement as amicus curiae, filed. BMM:gac.

12/2/83—STATEMENT of Federal Communications Commission as amicus curiae in lieu of brf, filed. BMM:gac.

12/5/83—Transmitted Motion (L-8) and statement of FCC to DSR/FDM/ J.H. Michael-U.S.D.J. on 12/5/83. BMM:gac.

12/14/83—ORDER granting motion of Federal Communications Commission for leave to file statement as amicus curiae, filed. SAW-zyj Copy to Emge; Sarver; Mathis-Morrissey-Stroud; Booker-Powell; Hall.

DOCKET ENTRIES

(United States District Court)

1983

Mar. 21—(1) — COMPLAINT and Attachments.

Mar. 22 — Magistrate Notice and L.R. 10-A to Counsel for Plaintiff.

Mar. 23—(2) — Motion of Plaintiff for Preliminary Injunction, Memorandum and Affidavits (2), and ORDER (MURRAY, J) (dated Mar. 21, 1983) DIRECTING Defendants reply to Motion on or before Mar. 28, 1983, and to

show cause at hearing April 6, 1983, why Motion should not be granted as therein set forth. (cc Attorney for Plaintiff 3/23/83).

Mar. 22—(3) — Local Rule 10-A Letter of Plaintiff.

Mar. 22—(4) — Motion of Plaintiff for Admission of Michael D. Stroud, *PRO HOC VICE*. C/S

Mar. 22—(5) — Summons issued. (cc, Magistrate Notice and Notice and Acknowledgement to Counsel for Plaintiff for service.) (All except Hamilton served 3/22/83; see entry No. 7) (Hamilton served 3/22/83, see entry No. 8).

Mar. 24—(6) — Stipulation and Order (Black, J) (dated 3/23/83) extending the time within which Defendant is to answer Show Cause Order to on or before 3/31/83. (c/m 3/24/83 jg)

Mar. 25—(7) — Affidavit of Service. (As to all Defendants except Hamilton.)

Mar. 31—(8) — Affidavit of Service.(As to Defendant, Wayne B. Hamilton)

Mar. 31—(9) — Opposition of Defendant, Public Service Commission of Maryland to Motion of Plaintiff for Preliminary Injunction and Answer to Show Cause Order; and Memorandum and Attachment. (c/s)

Mar. 31—(10) — Motion of Maryland Office of People's Counsel for Leave to Intervene; Memorandum; (c/s)

Mar. 31—(11) — Opposition of Proposed Intervenor, Maryland Office of People's Counsel to Motion of Plaintiff for Preliminary Injunction; and Attachments A and B. (c/s)

Apr. 6 — Hearing on Motion of Plaintiff for Preliminary Injunction held before Northrop, S.J. (Reporter: Mackaro)

Apr. 6 — Oral Motion of Plaintiff for admission of Michael G. Stroud, Esq. pro hac vice — "GRANTED.".

Apr. 6—(12) — Order (Northrop, S.J.) "GRANTING" Motion of the Maryland Office of People's Counsel for Leave to Intervene; making them a party Defendant in the case; and directing that the Proposed Answer of said Defendant shall stand as it's Answer. (c/m 4/6/83 cd)

Apr. 6—(13) — ANSWER of Defendant *MARYLAND OFFICE OF PEOPLE'S COUNSEL.*

Apr. 6—(14) — Order (Northrop, S.J.) "GRANTING" Motion of Plaintiff for Preliminary Injunction, with provisions as therein set forth. (c/m 4/6/83 cd)

Apr. 7—(15) — Memorandum (Northrop, S.J.). (c/m by chambers)

Apr. 8—(16) — ANSWER of Defendants *P.S.C., HEINTZ, BADGER, SCHIFTER, HAMILTON,* and *ARNOLD.*

Apr. 14—(17) — ANSWER of Defendant *HAWKINS.*

Apr. 14—(18) — Notice of Appeal (Received 4/11/83) of Defendants HEINTZ, BADGER, SCHIFTER, HAMILTON and ARNOLD from Order dated April 6, 1983. (Filing fee paid) (Transcript purchase order form mailed to counsel 4/18/83)

Apr. 19—(19) — Certificate of Defendants of intent not to order transcript and Statement of Issues.

Apr. 20—(20) — Order (Northrop, S.J.) Directing that case be "CLOSED" as therein set forth. MicroFilmed (c/m by chambers) (closed cah)

Apr. 21—(21) — Transcript purchase order form (copy) from Defendents, noting a transcript is not needed for the appeal, statement of issues attached. (See P1, #24)

Apr. 28—(22) — Designation of Plaintiff to Defendant of transcript to be included in Record.

May 3—(23) — Amended Notice of Appeal of Defendants. (c/m 5/3/83)

May 9—(24) — Letter (copy) from Defendants to Court Reporter, ordering transcript of proceedings as therein set forth.

June 27—(25) — Transcript of proceedings before the Court (Northrop, S.J.) taken on April 6, 1983. (Filed Separately)

United States District Court
District of Maryland

Civil Action No. N 83-855

The Chesapeake and Potomac Telephone
Company of Maryland
One East Pratt Street
Baltimore, Maryland 21202

Plaintiff,

v.

Public Service Commission of Maryland
Ronald Hawkins, Executive Director
Frank O. Heintz, Chairman,
William A. Badger, Commissioner,
Lilo K. Schifter, Commissioner,
Wayne B. Hamilton, Commissioner,
Haskell N. Arnold, Commissioner,
231 East Baltimore Street
Baltimore, Maryland 21202

Defendants.

COMPLAINT FOR DECLARATORY JUDGMENT AND PRELIMINARY AND PERMANENT INJUNCTIVE RELIEF

(Filed March 21, 1983)

Plaintiff, The Chesapeake and Potomac Telephone Company of Maryland, brings this action for a declaratory judgment that the refusal of the Defendants Maryland Public Service Commission and each of its members to allow Plaintiff to collect intrastate charges for telephone services to recover depreciation expense based on depreciation rates prescribed by the Federal Communications Commission is unlawful because (1) it expressly violates an FCC order that Defendants must use FCC-prescribed depreciation rates to determine the depreciation expense to be recovered from intrastate charges for telephone services; (2) it expressly violates Section 220(b) of the Federal Communications Act, 47 U.S.C. § 220(b), which directs the FCC to prescribe Plaintiff's depreciation rates; and (3) it conflicts with the Federal Communications Commission's preemption of inconsistent state prescriptions of depreciation rates which was intended to preclude state actions from frustrating national telecommunications policies adopted by the FCC under the Communications Act. Plaintiff asks that Defendants be permanently enjoined from preventing Plaintiff from collecting intrastate charges for telephone services to recover the depreciation expense based on Federal Communications Commission prescribed depreciation rates.

A preliminary injunction is also requested because (1) Plaintiff is losing $44,000 a day in revenues and is thus suffering substantial and irreparable harm; (2) customers would be completely protected from any harm by permitting Plaintiff to collect rates subject to refund with interest; (3) a serious question has been raised by this Complaint, and in another case directly on point, a preliminary injunction was issued; and (4) issuance of a preliminary injunction is in the public interest because it

will stop Defendants from obstructing national telecommunications policy.

Jurisdiction and Venue

1. This action arises under the Federal Communications Act, 47 U.S.C. §§ 151 *et seq.* ("Communications Act"), and the Federal Declaratory Judgment Act, 28 U.S.C. §§ 2201-2202. This Court has jurisdiction over this action under Section 401(b) of the Communications Act and under Sections 1331 and 1337 of Title 28 of the United States Code.

2. Venue exists in this district under 28 U.S.C. § 1391. The acts complained of occurred in this district, and the claims arose in this district. The Defendant Maryland Public Service Commission is an agency established by Maryland law, and it has its offices and performs its functions in this district at 231 East Baltimore Street, Baltimore, Maryland. The individual Defendants, who are the members of the Maryland Public Service Commission, all have offices at 231 East Baltimore Street, Baltimore, Maryland. The individual Defendants all reside within this district.

The Parties

3. Plaintiff, The Chesapeake and Potomac Telephone Company of Maryland ("C&P"), is a Maryland corporation with offices at Constellation Place, One East Pratt Street, Baltimore, Maryland. Plaintiff C&P provides interstate and foreign telecommunications services under the Communications Act. Plaintiff also provides intrastate telephone services in the State of Maryland.

4. Defendant Maryland Public Service Commission ("PSC") is a regulatory agency created and existing under law of the State of Maryland.

5. Defendants Frank O. Heintz, William A. Badger, Lilo K. Schifter, Wayne B. Hamilton and Haskell N. Arnold

are now, and were at the time of the acts complained of herein, the members of the Defendant PSC. Defendant Frank O. Heintz is now, and was at the time of the acts complained of herein, the Chairman of the Defendant PSC.

Substantive Allegations

The Structure of the Communications Act

6. The Communications Act provides a comprehensive scheme for the federal regulation of telecommunications by the Federal Communications Commission ("FCC") for the purpose of making available rapid, efficient, nationwide telecommunications service at reasonable charges. 47 U.S.C. §§ 151, 152. Among the powers given to the FCC to achieve this purpose is the power to prescribe depreciation rates for Plaintiff C&P. 47 U.S.C. § 220(b). Because Plaintiff C&P's telephone equipment is used to provide both interstate and intrastate telephone services, however, the FCC must afford Defendant PSC an opportunity to present its views before prescribing Plaintiff C&P's depreciation rates. 47 U.S.C. § 220(i). Moreover, the FCC may, in its discretion, refrain from prescribing Plaintiff C&P's depreciation rates in favor of Defendant PSC's prescription. 47 U.S.C. § 220(h).

The FCC's Prescription of Plaintiff's Depreciation Rates

7. The FCC, in a series of proceedings, prescribed depreciation rates for Plaintiff C&P. In each case, the FCC provided Defendant PSC notice and an opportunity to participate consistent with the requirements of the Communications Act and in each case Defendant PSC did participate.

(a) In *American Telephone & Telegraph Co.,* 88 F.C.C.2d 1223, 1252 (1982), the FCC prescribed depreciation rates for Plaintiff C&P's existing telephone plant, notwithstanding objections voiced by Defendant PSC and other state regulatory commissions in that proceeding.

(b) In *The Chesapeake and Potomac Telephone Co.,* 90 F.C.C.2d 964, 976 (1982), the FCC prescribed depreciation rates for Plaintiff C&P's new outside plant, notwithstanding objections voiced by Defendant PSC and other state regulatory commissions in that proceeding.

(c) In *American Telephone & Telegraph Co.,* FCC 82-576 (Dec. 30, 1982), the FCC prescribed depreciation rates to be used for Plaintiff C&P's new central office equipment, notwithstanding objections voiced by Defendant PSC and other state regulatory commissions in that proceeding. While Defendant PSC raised objections to each one of these FCC depreciation rate prescriptions, it did not appeal any of the FCC's final orders.

The Communications Act and Federal Telecommunications Policy Have Preempted State Commissions' Prescription of Conflicting Depreciation Rates

8. The FCC has ruled that Defendant PSC and other state commissions are required by the Communications Act, 47 U.S.C. § 220(b), to use the FCC-prescribed depreciation rates to determine the depreciation expense which must be recovered from intrastate charges for telephone services. Moreover, the FCC has preempted conflicting state prescriptions of depreciation rates because such state action frustrates federal policies and objectives "to develop . . . a dynamic, efficient telecommunications marketplace with services being provided at reasonable prices." *Uniform System of Accounts.* CC Docket No. 79-105, FCC 82-581, p. 15 (Jan. 6, 1983), *appeal pending sub. nom., Virginia Corporation Commission v. FCC,* 4th Cir. U.S. Ct. App., Case No. 83-1136 (*See* Attachment A; hereinafter referred to as the "Preemption Order"). The *Preemption Order* was regularly made and duly served on Defendant PSC, but it did not seek review of this order. While the *Preemption Order* has been appealed by another state commission, it has not been stayed pending appeal. *Virginia Corporation Commission v. FCC, supra.*

Defendants Have Refused To Use FCC-Prescribed Depreciation Rates To Set Plaintiff's Intrastate Charges

9. Based upon the *Preemption Order,* Plaintiff C&P requested Defendant PSC to set its intrastate charges to recover the depreciation expense based on the depreciation rates prescribed by the FCC. While the rate increase required to recover this depreciation expense totalled $16.1 million in annual revenue, or $44,000 a day, the impact on individual customers would have been very slight because it would amount to an increase of no more than 2.2%. On February 18, 1983, Defendant PSC in Order No. 66114 (*See* Attachment B) nevertheless refused to use the FCC prescribed depreciation rates to set Plaintiff C&P's intrastate charges for telephone services.

Plaintiff Is Being Substantially And Irreparably Harmed

10. Because Plaintiff C&P is experiencing a *daily* revenue shortfall of some $44,000, it is being substantially and irreparably harmed by Defendant PSC's refusal to abide by the FCC's *Preemption Order.* Under applicable regulatory law, Plaintiff C&P cannot retroactively recover these lost revenues. This irreparable harm can only be prevented during the pendency of this action by preliminarily enjoining Defendants from prohibiting Plaintiff C&P from collecting intrastate charges for telephone services based on FCC-prescribed depreciation rates. By contrast to the harm C&P is suffering, its customers can be completely protected from any harm of paying more than just and reasonable rates by Plaintiff C&P collecting these intrastate charges subject to refund with interest. Plaintiff C&P will clearly succeed on the merits because Defendant PSC cannot dispute that it violated the FCC's *Preemption Order.* Issuance of a preliminary injunction enjoining Defendants from preventing Plaintiff C&P from collecting intrastate charges for telephone services based on FCC-prescribed depreciation rates will

be in the public interest because it will stop Defendants from obstructing national telecommunications policy.

11. In an identical situation the United States District Court for the Western District of Washington recently entered a preliminary injunction prohibiting the Washington Utilities and Transportation Commission from refusing to set intrastate telephone charges of Pacific Northwest Bell Telephone Company to recover the depreciation expense based on FCC-prescribed depreciation rates. *Pacific Northwest Bell Telephone Co. v. Washington Utilities and Transportation Commission,* No. C83-214C, Memorandum Opinion (W.D. Wash., Mar. 10, 1983) (*See* Attachment C).

Causes of Action

Count I: Violation of FCC's Preemption Order

12. Plaintiff C&P realleges and incorporates by reference each and every allegation in paragraphs 1 through 11 hereof.

13. The Defendants' refusal to set Plaintiff C&P's intrastate charges to recover the depreciation expense from using the FCC-prescribed depreciation rates violates the *Preemption Order.*

14. As a direct result of Defendants' violation of the *Preemption Order,* Plaintiff C&P is suffering irreparable harm because it is being deprived of approximately $44,000 in revenues daily to which it is entitled and which it would be receiving if its intrastate charges for telephone services were set based on the depreciation rates prescribed by the FCC.

Count II: Violation of Section 220(b) of the Communications Act

15. Plaintiff C&P realleges and incorporates by reference each and every allegation in paragraphs 1 through 11 hereof.

16. The Defendants' refusal to set Plaintiff C&P's intrastate charges to recover the depreciation expense from using the FCC-prescribed depreciation rates violates Section 220(b) of the Communications Act.

17. As a direct result of Defendants' violation of the Communications Act, Plaintiff C&P is suffering irreparable harm because it is being deprived of approximately $44,000 in revenues daily to which it is entitled and which it would be receiving if its intrastate charges for telephone services were set based on the depreciation rates prescribed by the FCC.

Count III: Conflict With Federal Policy

18. Plaintiff realleges and incorporates by reference each and every allegation in paragraphs 1 through 11 hereof.

19. The Defendants' refusal to set Plaintiff C&P's intrastate charges to recover the depreciation expense based on the FCC-prescribed depreciation rates conflicts with the FCC's preemption of conflicting state action and therefore interferes with interstate commerce in violation of the Commerce Clause and the Federal Supremacy Clause of the United States Constitution. U.S. Const. Art. I, § 8 cl. 3; U.S. Const. Art. VI.

20. As a direct result of Defendants' violation of the Commerce Clause and the Federal Supremacy Clause of the United States Constitution, Plaintiff C&P is suffering irreparable harm because it is being deprived of approximately $44,000 in revenues daily to which it is entitled and which it would be receiving if its intrastate charges for telephone services were set based on the depreciation rates prescribed by the FCC.

Prayer for Relief

WHEREFORE, Plaintiff C&P respectfully requests that this Honorable Court:

(1) Pending a hearing upon the merits of this case, issue a preliminary injunction enjoining the Defendants from

the operation, enforcement or execution of that portion of PSC Order No. 66114 which prevents Plaintiff C&P from collecting intrastate charges for its telephone services to recover the depreciation expense based on the depreciation rates prescribed by the Federal Communications Commission;

(2) Issue a declaratory judgment that the Defendants' refusal to set Plaintiff C&P's intrastate charges for telephone services to recover the depreciation expense based on the depreciation rates prescribed by the Federal Communications Commission is unlawful because it violates the *Preemption Order*, the Communications Act, and the United States Constitution;

(3) Issue a mandatory and permanent injunction enjoining the Defendants from the operation, enforcement or execution of that portion of PSC Order No. 66114 which prevents Plaintiff C&P from collecting intrastate charges for its telephone services to recover the depreciation expense based on the depreciation rates prescribed by the Federal Communications Commission; and

(4) Grant such other and further relief which, to this Honorable Court, may be just or proper.

Respectfully submitted,

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Attorneys for The Chesapeake and Potomac Telephone Company of Maryland

ROBERT A. LEVETOWN
MARK J. MATHIS
MICHAEL J. MORRISSEY
Of Counsel

VERIFICATION OF COMPLAINT

I, J. Henry Butta, verify that I am Vice President of The Chesapeake and Potomac Telephone Company of Maryland, and that the matters and facts set forth in the foregoing Complaint are true and correct to the best of my knowledge and belief.

J. HENRY BUTTA

Subscribed and
sworn to before me
this 21st day of March,
1983

TERESA A. BOARMAN
Notary Public
Notary Public of Maryland
My Commission expires July 1, 1986.

ATTACHMENT A

Before the
Federal Communications Commission

Washington, D.C. 20554

FCC 82-581
32609

CC Docket No. 79-105 RM-3017

In the Matter of

Amendment of Part 31, Uniform System of Accounts for Class A and Class B Telephone Companies, of the Commission's Rules and Regulations with respect to accounting for station connections, optional payment plan revenues and customer provided equipment and sale of terminal equipment.

Petition for Declaratory Ruling on Question of Federal Preemption Involving Order Of the Public Utilities Commission of Ohio in Conflict with (i) FCC Prescriptions Under Section 220 of the Communications Act and (ii) Established FCC Policies.

MEMORANDUM OPINION AND ORDER

Adopted: *December 22, 1982* Released: *January 6, 1983*

By the Commission: *Commissioner Fogarty issuing a separate statement.*

1. The Commission has before it a Petition for Reconsideration filed on June 7, 1982, by the American Telephone and Telegraph Company, on behalf of itself and the associated Bell System Operating Companies (AT&T). AT&T seeks reconsideration of the Commission's decision in *Amendment of Part 31,* 89 FCC2d 1094 (1982) (hereinafter cited as *Preemption Order*), in which the Commission determined that Sections 220(a) and 220(b) of the Communications Act of 1934, as amended, 47 U.S.C. 220(a) and 220(b), did not preempt state commissions from applying different accounting and depreciation procedures for purposes of intrastate ratemaking proceedings.[1] The *Preemption Order* was a reconsideration of *Amendment of Part 31,* 85 FCC2d 818 (1981) (hereinafter cited as *Expensing Order*).

2. The Commission also has before it a Petition for Declaratory Ruling filed on June 7, 1982, by General Telephone Company of Ohio (GTE of Ohio). This petition requests that the Commission preempt an order of the Public Utilities Commission of Ohio (Ohio) that denied GTE of Ohio the same depreciation rates for intrastate purposes as had been prescribed by this Commission. GTE of Ohio contends that Section 220(b) established the rate prescribed by the Commission as the only depreciation rate the company could utilize.

[1] On June 8, 1982, GTE Service Corporation, on behalf of itself, United Telephone System, Inc., and Continental Telecom, Inc. (hereinafter referred to as GTE), filed a Petition for Clarification of the Commission's *Preemption Order.* This petition was dismissed as untimely. *Amendment of Part 31,* Mimeo No. 4766 (released June 24, 1982). However, the Commission stated that it would consider the substance of the petition in connection with AT&T's petition.

3. The Commission established a joint reply period for the two petitions, utilizing the pleading cycle for comments in response to the Petition for Reconsideration, and allowed parties to cross-reference their pleadings where appropriate. In addition to pleadings filed by the petitioners and the GTE parties, comments or reply comments were filed by the Arkansas Public Service Commission (Arkansas), Ohio, the People of the State of California and the Public Utilities Commission of the State of California (California), the Virginia State Corporation Commission (Virginia), the National Association of Regulatory Utility Commissioners (NARUC), the United States Independent Telephone Association (USITA), the Office of Consumers' Counsel, State of Ohio (Consumers' Counsel), the United Telephone System Inc. and the Idaho Public Utilities Commission (Idaho). A summary of the comments is contained in Appendix A. Below we consider the issues raised on reconsideration, after which we shall consider the question presented by GTE of Ohio's Petition for Declaratory Ruling.

I. *Background*

4. In *Docket No. 19129,* 64 FCC2d 1, 54-56 (1977), we concluded that it would be desirable to have the causative rate payer bear the costs associated with station connections. We directed AT&T to file a plan for accomplishing this objective. Following AT&T's submission we initiated this proceeding, albeit with a somewhat different approach for modifying the accounting for station connections than proposed by AT&T.

5. After reviewing the comments, we concluded that the drop, block and protector portion of station connections should not be included in any accounting or regulatory

revisions. We also concluded that our objective of placing the costs of station connections on the cost causative customer could not be achieved by means of an accounting change alone. This is so because costs associated with the provision of inside wiring must be apportioned between the federal and state jurisdictions as long as inside wiring is provided as a tariffed service subject to dual jurisdiction. Complete unbundling could be achieved by requiring inside wiring to be provided on a detariffed basis, as was done with customer premises equipment. Accordingly, we initiated a further inquiry to explore the detariffing concept further, *Amendment of Part 31*, 86 FCC2d 885 (1981).

6. Nevertheless, we concluded that changes in accounting and depreciation procedures that would begin expensing the inside wiring portion of the station connection account would be in the public interest, and would facilitate the deregulation of the provision of inside wiring if the Commission should later decide to take that approach. The principal changes required that future costs of installing inside wiring and similar costs be included as an expense in Account 605, Repair of Station Equipment. Such costs were previously capitalized in Account 232, Station Connections. The expensing of these costs would be phased in over a four year period unless a carrier obtained state commission approval to expense one hundred percent immediately. The *Expensing Order* also required that the present net investment in inside wiring and the investment capitalized during the phase-in period be amortized over a ten year period. These expensing and amortization rules replaced the depreciation procedures that had previously applied to the inside wiring portion of the station connections account.

7. On reconsideration, we concluded that the *Expensing Order* was not intended to preempt state commissions from utilizing other depreciation or accounting procedures for intrastate ratemaking proceedings, unless such preemption occurs as a matter of law. Our discussion was

based in part on an assumption that most or all of the state commissions would follow our lead. We also indicated that Section 220 does not preclude state commissions from departing from accounting and depreciation rules prescribed by this Commission for purposes of regulating intrastate communications services. In reaching this conclusion, we reviewed Section 20(5), the Interstate Commerce Act predecessor of the accounting and depreciation provisions contained in Section 220. We concluded that nothing in the history of Section 20(5) provided any indication of whether that provision had been intended to preempt state commissions from prescribing divergent depreciation rates when the Interstate Commerce Commission (ICC) had prescribed a rate. We stated:

> [i]nasmuch as Section 20 had never been construed to restrict state commissions from requiring carriers to keep additional records for purposes of intrastate ratemaking and court decisions in analagous contexts did not adopt an expansive interpretation of that provision, the reenactment of that language should not be interpreted to restrict state commissions from keeping such additional records in the absence of clear evidence that the 1934 Congress intended to produce that result.

Preemption Order, supra at 1102.

8. We also reviewed the legislative history of the Communications Act and concluded that Congress had been uncertain of the preemptive effect of reenacting the Interstate Commerce Act language and that it apparently did not want to resolve the question at that time. We concluded that Congress had been attempting to obtain as much uniformity as possible without coercing any state commission to use ratemaking methods which it might find unacceptable. We found that we had proceeded in a manner consistent with this purpose for nearly four decades, noting that we had recognized divergent practices by state commissions from time-to-time. The language of Section 2(b)(1) was found to support the interpretation

that state commissions are not precluded from applying different accounting and depreciation procedures from this Commission. The *Preemption Order* concluded by finding that nothing in the Act precluded us from preempting state commission actions that might interfere with or tend to frustrate policies or rules we have adopted to carry out statutory objectives with respect to interstate or foreign communications, but we also found that federal regulation would not be frustrated if carriers maintain additional records for intrastate ratemaking purposes.

II. *Discussion*

9. The question presented in the reconsideration petition is a clearly delineated controversy over whether Section 220(b) preempts state depreciation prescriptions that are inconsistent with the rates prescribed for classes of property by this Commission, or, whether Section 2(b)(1) or Section 221(b) reserve to the states the right to prescribe their own depreciation rates for intrastate regulatory purposes. Alternatively, it is argued that the Commission should preempt inconsistent state depreciation rates pursuant to its authority to preempt state actions which would frustrate or interfere with the accomplishment of federal objectives. *See North Carolina Utilities Commission v. FCC*, 537 F.2d 787 (4th Cir. 1976), *cert. denied*, 429 U.S. 1027 (1976) (hereinafter cited as *NCUC I*). The *Preemption Order* was the first time the Commission had squarely addressed the preemptive effect of a prescribed depreciation rate, despite having prescribed rates for more than thirty years. No federal court has addressed the question of the preemptive effect of a Commission prescribed depreciation rate.[2]

[2] The United States Supreme Court has held that state commissions may prescribe depreciation rates where the empowered federal commission has not prescribed rates. *Northwestern Bell Telephone Co. v. Nebraska State Railway Comm.*, 297 U.S. 471 (1936). The Court specifically reserved judgment on the effect of prescribed rates by the federal commission.

10. It is argued that the Commission erred in the earlier decision by concentrating on Sections 220(a) and 220(g) rather than properly analyzing Section 220(b), the provision dealing directly with depreciation. A careful review of AT&T's and GTE's pleadings and a thorough reevaluation of the entire question of the Commission's depreciation jurisdiction leads to the conclusion that the evaluation in the *Preemption Order* did not sufficiently consider the effect of Section 220(b). Accordingly, we shall undertake to evaluate anew the scope of the Commission's jurisdiction under Section 220(b).

11. Before turning to the analysis of the statutory provisions, it is necessary to understand the relationship between capitalizing and expensing a transaction or economic event. When an event is capitalized, its cost is recorded on the company's books to be recovered over some future period through depreciation charges to operating expense. Depreciation as used here is an accounting convention for allocatively spreading the original cost, less net salvage, over the useful life of a capital asset. Thus, for there to be depreciation there must be costs that are to be recovered over more than one accounting period. However, when the decision to expense is made, all costs are to be recovered at one time. Thus, the decision to expense is a determination that there is no category of asset for which depreciation expense will be allowed. It is therefore clear that the decision to commence expensing the inside wiring portion of station connections involves questions of depreciation policy.

12. The law is clear that federal regulation should not be presumed to preempt state regulations without clear evidence of either congressional design to preempt the field or that state regulatory activities would obstruct the accomplishment and execution of the full purposes and objectives of Congress. *Florida Lime and Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 141 (1963), *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941). Our review reveals that both criteria are satisfied in this case. In reaching

this conclusion we analyzed the language of Section 220, the legislative history, relevant court cases, and our regulatory objectives.

A. *Statutory Language*

13. The Commission's express jurisdiction with respect to depreciation is set forth in Section 220(b). That section provides:

> The Commission shall, as soon as practicable, prescribe for such carriers the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. Such carriers shall not, after the Commission has prescribed the classes of property for which depreciation charges may be included, charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or, after the Commission has prescribed percentages of depreciation, charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. No such carrier shall in any case include in any form under its operating or other expenses any depreciation or other charge or expenditure included elsewhere as a depreciation charge or otherwise under its operating or other expenses.

14. The plain language of the statute is express and unequivocal. Section 220(b) says the Commission "shall" make depreciation prescriptions, and that carriers "shall not" charge depreciation different than that prescribed by the Commission. That this preempts inconsistent state action is further indicated in Section 220(h) which gives the Commission discretion to "except" carriers from the requirements of Section 220 "where such carriers are subject to state commission regulation."

15. The requirement of Section 220(i) that states be given an opportunity to comment before the Commission prescribes "any requirements as to accounts, records and memoranda" is consistent with an interpretation that states are preempted when the Commission has acted in the depreciation area. By providing that states be given notice, Congress ensured that state needs for accounts, records and memoranda brought to the Commission's attention would be considered. Such a procedure assures that the states' needs and legitimate interests are met.

16. In setting the duties of the Commission and the prohibitions on the carriers subject to the Act, Congress spoke of depreciation in general terms without any attempt to make distinctions between either "intrastate" or "interstate" property. This is significant because when Congress wanted to make such distinctions in the Act it did so. See, *e.g.*, 47 U.S.C. 221(c) and (d), and 410(c). The fact that Congress did not make such a distinction here indicates that it intended no distinction.

17. Taken as a whole, the language of Section 220 appears clearly to preempt the states in connection with depreciation expense determinations and the related accounting. The language strongly implies that the states may not depart from depreciation rules prescribed by the FCC unless the Commission in its discretion allows them to do so. Otherwise, the federal statute would govern state depreciation practices in form only, allowing the states to treat substantive depreciation matters as they might choose. While that might be a plausible construction of Section 220, after full analysis we do not believe that Congress intended such a feeble gesture. There would be little purpose to require the carriers to keep all their books pursuant to an FCC prescription, and then allow the states to require the carriers to follow inconsistent depreciation practices. Instead, the language of the section and the comprehensive treatment given to this matter by the Congress demonstrate that more was intended. Accordingly, we find that the statutory language indicates

that FCC depreciation prescriptions are to be followed in both the federal and state jurisdictions unless the FCC provides otherwise. As demonstrated below, this construction is also consistent with the legislative history.

B. *Legislative History*

18. In the *Preemption Order* we found that the legislative history of Section 220 was inconclusive and at most indicated that Congress was "not sure" about the preemptive effect of the new legislation. 89 FCC2d at 1106. However, the reconsideration petition and comments supporting it show that Congress believed that the language ultimately adopted would preempt the states from prescribing depreciation rates for subject carriers when the Commission had prescribed rates.

19. In our *Preemption Order,* we observed that Section 220 of the Communications Act had been adopted from Section 20 of the Interstate Commerce Act, and our review of the few ICC cases touching upon preemption did not reveal the ICC to have possessed the kind of broad preemptive power now urged by GTE and AT&T. However, after reviewing the pre-1934 cases again, we find that, while not dispositive, they lean more toward GTE and AT&T's views than against them.

20. The closest the ICC came to delineating its position on this matter came in *Depreciation Charges of Telephone Companies,* 118 I.C.C. 295, 332 (1926), where it said:

> It seems to be well established that where a local telephone company undertakes to originate or deliver toll messages, and most of them do so undertake, practically all of its property is open for use in interstate commerce and at any time may be so used. Under such circumstances, no doubt would seem to exist as to the power of Congress to regulate the accounting practices of such companies with respect to their property, including the accounting for depreciation.

In the *Preemption Order* we focused on the fact that the ICC had not actually prescribed depreciation rates and thus there was uncertainty regarding the ICC's actual authority. However, after reviewing that case again we find that the better and more sensible interpretation is that if the ICC had prescribed depreciation rates, the state commissions would have been precluded from prescribing rates that diverged from those it prescribed. We cited *Smith v. Illinois Bell Tel. Co.,* 282 U.S. 133, 159 (1930), in the *Preemption Order* as supporting our conclusion that the ICC decision did not preempt the states. In that decision the Supreme Court held that absent ICC action prescribing depreciation rates, Section 20(5) did not preclude states from prescribing depreciation rates. Since the ICC proceeding did not actually prescribe depreciation rates, but only began a proceeding looking toward the ultimate prescription of depreciation rates, there were no depreciation rates prescribed that could have preempted state-prescribed depreciation rates. Thus *Smith* only stands for the proposition that until the ICC actually prescribed rates, there was no basis for preempting the states. It did not reach the question of whether Section 20(5) would preempt the states if the ICC prescribed depreciation rates[3]

21. At the hearings pertaining to the Communications Act the then chairman of the ICC indicated his belief that the ICC depreciation rulings would govern both federal and state depreciation practices:

> Paragraph (j) . . . should be most carefully considered. It unquestionably directly conflicts with,

[3] Similarly, *Interstate Commerce Commission v. Goodrich Transportation Co.,* 224 U.S. 194 (1912) and *Kansas City Southern Ry. Co. v. I.R.S.,* 52 F.2d 372 (8th Cir. 1931) do not appear to have any pertinence to the issue at hand. As noted in 89 FCC2d at 1099, *Goodrich* did not raise any question with respect to the effect of ICC accounting rules upon activities not subject to ICC rate regulation. The *Kansas* holding simply reconciles two federal statutes, the Internal Revenue Code and the Interstate Commerce Act. It did not purport to establish new law on state preemption.

and destroys the uniformity of systems of accounts and depreciation accounting required by the preceding provisions of the section. That is not true under the present law.[4]

22. Other witnesses who appeared at the hearings repeated the same view. See statements of Mr. Gifford,[5] Mr. Benton,[6] and Dr. Irvin Stewart.[7]

23. The *Preemption Order* relied heavily on the "silence contained in the Congressional Reports," 89 FCC2d 1105, in concluding that the legislative history did not support a finding that Section 220 was intended to preempt state commissions from prescribing their own depreciation rates for intrastate purposes. However, a reexamination of the legislative history in light of the comments on reconsideration indicates that the committee reports accompanying the bills did contain language indicating that the committees believed that the predecessor provision had preempted the states. The House Report, in discussing the Section 220(j) provision (which was not adopted) that would have reserved jurisdiction over depreciation rates to the states for purposes of intrastate ratemaking, stated that the provision was "responsive to the requests of the State commissions that the present law be *changed so as to permit* those bodies to exercise, for State purposes, certain jurisdiction over . . . depreciation accounting."[8]

[4] Ltr. of F. McManamy, Hearings on S. 2910, p. 208.

[5] Hearings on H.R. 8301, pp 191-192 (See 89 FCC2d at 1105, fn.17). The *Preemption Order* had indicated that Mr. Gifford's preemption views were tentative. However, careful review of that testimony reveals that Mr. Gifford's uncertainty may have concerned the date Section 20(5) was enacted, not preemption.

[6] Hearings on S. 2910, 73rd Cong., 2d Sess., p. 181 (1943).

[7] Hearings on H.R. 8301, 73rd Cong., 2d sess., p. 17 (1934).

[8] H.R. Rep. No. 1850, 73rd Cong., 2d Sess. 7 (1934) (emphasis added). The section (j) proposed by the House would have provided: "Nothing in this section shall (1) limit the power of a State commission to prescribe, for the purposes of the exercise of its jurisdiction with respect to any carrier the percentage rate of depreciation to be charged to any class of property of such carrier, or the composite depreciation rate, for the purpose of determining charges, accounts, records, or practices; (2) relieve any carrier from keeping any accounts, records, or memoranda which may be required to be kept by any State commission in pursuance of authority granted under State Law." H.R. 8301, 73rd Cong., 2d Sess. Section 220(i) (February 27, 1934).

24. In remarks on the House floor, Representative Rayburn, Chairman, House Committee on Interstate and Foreign Commerce explained Section 220 of the proposed bill as follows:

> [p]aragraphs (a) to (g), relating to accounts records, memoranda, and depreciation, is based upon sections 20(5) to (8) of the Interstate Commerce Act with *changes necessary to permit State commissions to prescribe* the systems of accounts for the intrastate operation of carriers. Paragraphs (h) to (j) are new . . . *paragraph (j) removes any limitation upon the power of a State commission to prescribe, for the purposes of the exercise of its jurisdiction, rates of depreciation.* The last three paragraphs named were placed in the bill at the request of the State commissions which feel that their task of regulating intrastate communications will be greatly facilitated by the adoption of these paragraphs.[9]

25. The Senate version of Subsection (j) took a totally different approach than the House version. It called "for investigation and report to Congress instead of immediately turning over these matters to the State." S. Rep. No. 781, 73rd Cong., 2d Sess. 5 (1934).[10] The version of Section

[9] 78 Cong. Rec. 10314 (1934) (emphasis added).

[10] The Senate version of Section 220(j) provided: "The Commission shall investigate and report to the Congress whether in its opinion legislation is desirable (1) authorizing the Commission to except the carriers of any particular class or classes in any State from any of the requirements under this section in cases where such carriers are subject to State commission regulation with respect to matters to which this section relates; and (2) permitting the State commissions, in pursuance of authority granted under State Law, to prescribe

220(j) finally enacted was the result of agreement in the conference committee. The conferees agreed to adopt the House provisions as to Sections 220(h) and (i), but decided against the House Section 220(j) proposal to remove any limitation upon the power of states to prescribe rates of depreciation. Instead, Section 220(j) was modified along the lines of the Senate proposal to require the Commission to "investigate and report to Congress as to the need for legislation to define or further harmonize the powers of the Commission and of State commissions with respect to other matters to which this section relates." Conf. Comm. Rep. No. 1918, 73rd Cong., 2d Sess. 17 (1934). The obvious inference to be drawn is that the conferees were not prepared at that time to allow the states to prescribe depreciation rates different than those established at the federal level, but that matter might be considered later if the report required by Section 220(j) indicated it to be appropriate.

26. The hearing testimony and Committee reports therefore indicate that the language being recodified from Section 20(5) of the Interstate Commerce Act preempted the state commissions' jurisdiction over depreciation. The rules of statutory construction provide that where Congress reenacts a provision from an existing statute, it intends that the construction applicable to the existing provision apply as well to the new provision.[11] The legislative history thus supports the actual language of Section 220(b) and indicates that Congress intended to preempt state commission jurisdiction over depreciation rates for subject carriers when it recodified the language from the Interstate Commerce Act. Accordingly, we conclude that the analysis of the legislative history

their own percentage rates of depreciation or systems of accounts records, or memoranda to be kept by carriers." S. 3285, 73rd Cong., 2d Sess. Section 220(j) (March 28, 1934).

[11] Courts have given weight to interpretations of the Interstate Commerce Act in interpreting the Communications Act. See, *e.g., American Telephone and Telegraph Company v. FCC*, 487 F.2d 865 (2d Cir. 1973).

contained in the comments of AT&T and GTE accurately represents the intent of Congress and that the more persuasive reading of the legislative history supports the construction that Section 220(b) preempts inconsistent state action where the Commission has prescribed depreciation rates for a carrier.

C. *Administrative and Court Decisions*

27. The *Preemption Order* cited *Accounting Rules for Telephone Companies*, 203 ICC 13 (1934), as evidence that the FCC could not preempt state depreciation practices. There the ICC recognized that states might have additional accounting needs and indicated that it had permitted state-prescribed sub-accounts within the federally-required books of account. However, the adoption of a blanket subdivision rule does not lead to the conclusion that federally adopted accounting and depreciation rules are not preemptive. Rather, it reflects an awareness that state commissions may have special data requirements to properly administer their regulatory policies which may require additional detail beyond that prescribed by the federal agency. A subdivision rule, however, does not permit what is accounted for as an expense to be capitalized in the guise of subdividing an expense account. While we may allow subdivisions of accounts, we will not allow inconsistent accounting or depreciation methods unless such practices are otherwise consistent with the public interest. Any other policy would obliterate the prescriptive effect of our adoption of a uniform system of accounts.

28. In fact we have approved variations from the prescribed uniform system of accounts. For example, our rules give carriers blanket authority to subdivide certain prescribed accounts "provided such subdivisions do not impair the integrity of the accounts prescribed." 47 C.F.R. 31.01-2(d)(1). C.F. 31.01-2(f), authorizing carriers to subdivide accounts "in the manner ordered by any state commission having jurisdiction. . . ." We also have approved state commission rate making treatment of plant

under construction different from that adopted by us. See 89 FCC2d at 1107.

29. There may well have been some instances of inconsistent state treatment of depreciation in the past. However, we do not seek controversy unless it is necessary to protect vital federal interests. Either such instances did not come to our attention or they may not have appeared threatening to federal interests.[12] In the past the communications marketplace was typified by monopoly conditions and life and salvage factors underlying the state rates were generally very similar, if not identical, to those used by the Commission. In that environment it was not essential that the Commission assert all the authority granted it. See *Computer and Communications Industry Association v. FCC*, No. 80-1471 (D.C. Cir. November 12, 1982). As discussed, *infra.*, in the more competitive conditions prevailing today, the utilization of proper methods and rates is more critical if the proper incentives are to be created to insure that the marketplace will function efficiently to bring the benefits of that competition to the ratepayers of this country. Therefore, where it is necessary to protect important federal policies against frustration by inconsistent state actions, we will exercise the full breadth of our depreciation powers. *See* para. 14 above.

30. Nor is there any merit to the argument that federal preemption of depreciation practices constitutes intrastate ratemaking which might run afoul of 47 U.S.C. 152(b). Section 220(b) only prohibits the states from setting depreciation rates for telephone property inconsistent from those prescribed by the FCC. It does not require that any particular tariff for intrastate service be accepted by the state commissions. The setting of depreciation rates and

[12] *Pacific Telephone and Telegraph Company v. California*, 401 P.2d 353 (1965), was cited in the *Preemption Order* to support nonpreemption. However, the California Supreme Court did not analyze Section 220(b) or its legislative history and its determination is therefore unpersuasive.

classes of depreciable property only resolves a single issue impacting the ratemaking process. It does not restrict the state commission's broad discretion in setting charges for individual services. In any event, Section 2(b) of the Act, 47 U.S.C. 152(b), has a well defined purpose which would not be implicated here: "to restrain the Commission from interfering with those essentially local incidents and practices of common carriage by wire that do not substantially encroach upon the administration and development of the interstate telephone network." *NCUC I, supra* at 794 n.6. Here the setting of depreciation rates is not an essentially local incident or practice and it has substantial effects upon the administration and development of the interstate telephone network.[13]

D. *Preemption Under Federal Supremacy*

31. Even if one were to assume that Section 220(b) did not automatically preempt the states whenever this Commission has acted, federal preemption of inconsistent state depreciation would be justified in this case to avoid frustration of validly adopted federal policies. The Fourth Circuit has stated:

> We have no doubt that the provisions of section 2(b) deprive the Commission of regulatory power over local services, facilities and disputes that in their nature and effect are separable from and do not substantially affect the conduct or development of interstate communications. But beyond that, we are not persuaded that section 2(b) sanctions any

[13] Nor is federal preemption of depreciation practices inconsistent with 47 U.S.C. 221(b).

Section 221(b) was intended to reserve state jurisdiction over exchange rates where exchange boundaries extend over two states. That provision was not intended to create new reservations to the states beyond that contained in Section 2(b) and the narrow circumstance encompassed by interstate exchanges. See *Computer and Communications Industry Association v. FCC, supra*, and *North Carolina Utilities Commission v. FCC*, 552 F.2d 1036, 1046 (4th Cir. 1976), *cert. denied*, 434 U.S. 874 (1977) (hereinafter cited as *NCUC II*).

state regulation, formally restrictive only of intrastate communication, that in effect encroaches substantially upon the Commission's authority under sections 201 through 205.

NCUC I, supra at 793. To the same effect, see *Computer and Communications Industry Association v. FCC, supra* at 35.

32. The D.C. Circuit recently addressed the preemption question, observing:

> We fail to see any distinction in this case between preemption principles applicable to state ratemaking authority and those applicable to other state powers. The operative principle [is that] . . . preemption of state tariffs on CPE is justified because state tariffs would interfere with the consumer's right to purchase CPE separately from transmission service and would thus frustrate the validly adopted federal policy.

Id. at 38. The court went on to find that conflicting state regulation may be preempted even though there is some indirect effect on state ratemaking discretion, noting:

> the Act itself does not distinguish between authority over rates and authority over other aspects of communications. Sections 2(a) and (b) of the Act allocate federal and state authority with regard to both "charges [and] . . . facilities." Therefore, conflicting federal and state regulations regarding dual use CPE are no more acceptable under the Act when equipment rates are involved, as here, than when interconnection policies are involved, as in the *NCUC* cases.

Id. at 38-39.

33. The provision for adequate capital recovery is important to "make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide, world-wide wire and radio communication service with adequate facilities at reasonable charges. . . ." 47 U.S.C.

151. State depreciation rate prescriptions that do not adequately provide for capital recovery in the competitive environment, which constitutes this Commission's policy in those markets found capable of supporting competition, would frustrate the accomplishment of that policy and are preemptable by this Commission.

34. Over the past decade the Commission has embarked in several areas of telecommunications to pursue a policy of encouraging competition wherever the market conditions will support such a policy and produce benefits to the public interest. In *MTS-WATS Market Structure Inquiry,* 81 FCC2d 177 (1980), the Commission opened the domestic MTS-WATS market to competitive entry, reserving the question of entry to Alaska to a later phase since concluded with the adoption of a similar open entry policy, *MTS-WATS Market Structure Inquiry,* FCC 82-515 (released November 30, 1982). In *Computer Inquiry II,* 77 FCC2d 384 (1980), *recon.,* 84 FCC2d 50 (1980), *recon.,* 88 FCC2d 512, *aff'd sub nom., Computer and Communications Industry Association v. FCC, supra,* the Commission opened the areas of enhanced services and customer premises equipment to competitive provision. These are just two examples of the policies which the Commission has pursued. However, they do point up the fact that if this policy is to be successful, it will be necessary for the marketplace to operate efficiently. Such efficient operation requires proper price signals generating from supply and demand conditions.

35. Capital recovery is an important determinant of the price at which services can be offered and significantly affects the amount of facilities provided to supply the needs of the communications industry. In *Amendment to Part 31,* 83 FCC2d 267 (1980), *recon.,* 87 FCC2d 916 (1981), the Commission adopted remaining life and straight line equal life group depreciation methods that recover capital on a basis that approximates straight line unit depreciation more closely than did the previously used methods. More timely capital recovery was antici-

pated to result in faster technological innovation with its accompanying benefits of more efficient service provision and lower costs resulting from more productive use of facilities.

36. Capital recovery issues are important in the implementation of *Computer Inquiry II* due to the part depreciation plays in the determination of net book value and the resultant gain or loss that may occur on the transfer of assets to the new subsidiary. It will also be significant in any later transfer of assets from the provision of regulated service to unregulated service or vice-versa. Thus, appropriate capital recovery will ease the regulatory burdens associated with supervising the transition to the new structure.

37. Depreciation is a significant portion of the revenue requirement of the regulated telephone companies. As such, it plays an important role in determining the price at which they offer their services. If competition is to be viable, it is necessary for prices to reflect depreciation expenses that are realistic for a competitive market. Absent such depreciation levels, improper signals will be given to the market. Since most plant is used interchangeably to provide interstate and intrastate communications service, supply and demand is determined by the combination of inputs from service demand in both regulatory jurisdictions. Approximately 75 percent of exchange plant is allocated to the intrastate jurisdiction. It is clear that unless telephone plant, including that portion subject to allocation to the intrastate jurisdiction, is depreciated at a reasonable rate, improperly timed capital recovery will occur. Indeed, in an increasingly competitive environment, it is possible that improper capital recovery could delay or prevent modernization which would add to the costs borne by ratepayers and could, ultimately, threaten carriers' ability to fully recover their invested capital. Moreover, the extent of state action attempting to prevent carriers from utilizing our depreciation prescriptions places substantial burdens on carriers

and could well impair their ability to raise the investment capital they will need to fully compete in the continually evolving competitive telecommunications marketplace.[14] Such a result could undermine the achievement of the Commission's objective to develop policies that will engender a dynamic, efficient telecommunications marketplace with services being provided at reasonable prices.

38. NARUC contends that preemption with respect to station connections is unnecessary and will not produce competitive benefits because expensing is not the same as unbundling. While NARUC is correct in a strict sense, it avoids the critical issue, which is the proper timing of cost recovery. If the Commission preempts with respect to station connections and all states must expense these costs, current ratepayers will be paying these costs instead of future ratepayers as would be the case with capitalization. Thus, future prices will reflect the appropriate costs for providing those services. Moreover, if these costs are expensed and state commissions must allow rates to cover these costs, it is likely that the cost causative ratepayer will in many cases be charged for the costs being expensed in connection with the provision of inside wiring. Thus, the Commission's objective may be substantially achieved by preempting state commissions from departing from our expensing rules.

39. In 1971 Congress amended the Communications Act to change the procedures for allocating costs between

[14] AT&T and GTE indicate several state commissions have refused to follow, have indicated an intent not to follow, or are being urged not to follow Commission determinations with respect to the expensing of inside wiring and/or the adoption of straight-line equal life group or remaining life depreciation methods. A staff review of state action in conjunction with AT&T intrastate tariff proceedings reveals that all but two states have approved expensing of station connections, that 13 states have rejected and 12 have approved equal life group depreciation, and that 9 states have rejected and 22 have approved remaining life group depreciation. Prior to issuing our *Order* in this docket we did not expect that such significant variance would be required by states.

federal and state jurisdictions by adding Section 410(c). The Commission was given the ultimate authority with respect to such allocations, further solidifying its superintendency over common carrier communications. See *NCUC I, supra* at 795. Section 410(c) procedures provide for uniformity in the separations process, thereby insuring that plant, expenses and revenues will be rationally accounted for in the dual jurisdictional environment. The utilization of one depreciation rate is the most effective method for insuring that this uniformity will be maintained and to insure that no jurisdiction bears a greater burden than another in the transition to a fully competitive marketplace. Several parties suggest that under or over recovery will result from one jurisdiction or another because of the shifting usage patterns for telephone plant over time and argue that if such a result were to occur, significant inequities would result to both ratepayers and carriers. A uniform depreciation rate for each class of property applicable to all property whether allocated to the federal or state jurisdiction clearly eliminates these potential problems.

40. For all of these reasons, it is apparent to us that a substantial impact on federal policies could result if state commissions were allowed to diverge from Commission prescribed depreciation rates and practices. Accordingly, it is essential to preempt inconsistent state depreciation practices to avoid frustration of these vital national policies.

III. *Declaratory Ruling Petition.*

41. GTE of Ohio seeks to have the Commission preempt an order of the Ohio Public Utilities Commission that did not approve remaining life and equal life group rates for intrastate ratemaking purposes. As alleged by GTE of Ohio, the differential in rates amounts to seven million dollars per year. GTE of Ohio states that failure of this Commission to preempt the state will frustrate the achievement of federal policies adopted by this Commission. Its argument is similar to those cited in connection with the reconsideration petition.

42. Essentially the same arguments are made against the GTE of Ohio petition as were urged on reconsideration with regard to the substance of the issue. However, Ohio cites an Ohio statute that precludes the state commission from adopting remaining life depreciation for intrastate purposes.

43. One procedural argument is raised by Ohio with respect to the petition. It contends that the question presented is premature since the order is subject to further reconsideration before the Ohio Commission pursuant to a request filed by GTE of Ohio. We do not agree since the purpose of declaratory rulings is to give guidance to affected persons in areas where uncertainty or confusion exists. A case or controversy in the judicial sense is not required, *NCUC I, supra* at 790-1. In this case, it appears necessary to issue such a ruling to clarify for the state commissions and the carriers the effect of our depreciation prescriptions. The fact that reconsideration proceedings are under way in Ohio does not mitigate against such a course in light of the divergencies from this Commission's depreciation methods and rates that are occurring to the detriment of federal policies. Thus, we find it imperative to declare today that inconsistent state prescribed depreciation rates are preempted by the Communications Act and are accordingly void. The existence of a state statute preventing a state commission from adopting a particular method does not affect this determination. When federal preemption is involved, there is no difference between a statute or a regulation of a state commission. Both must fall in the face of overriding federal concerns and policies.

IV. *Conclusion*

44. We have carefully reviewed the record upon reconsideration. The issues raised concerning the *Preemption Order* caused us to reevaluate the statutory language of Section 220(b), the legislative history of the provision, and

the relevant judicial and administrative proceedings relating to the subject. Our considered judgment after this review is that the *Preemption Order* must be reconsidered. We find that the most logical and reasonable interpretation of Section 220(b) of the Act is that where the Commission prescribes depreciation rates for classes of property, state commissions are precluded from departing from those rates. Since the depreciation method utilized is a material part in determining the rate to be applied, state commissions are also precluded from departing from the depreciation methods prescribed by the Commission. Thus, the *Expensing Order* is binding upon state commissions and they must expense additions to inside wiring in accordance with the plan established therein. Moreover, they must follow the amortization procedures adopted in that decision for the embedded inside wiring and any additions to the capitalized amount as a result of the phase-in of the expensing of inside wiring.

45. Even if Section 220(b) does not preempt state commissions, we would act under our authority to preempt state actions that interfere with the accomplishment of federal policies and objectives. *Computer and Communications Industry Association v. FCC, supra,* and *NCUC II.* We note that petitioner and the parties supporting the petition cite several states that have indicated they do not intend to follow the Commission's depreciation prescriptions or expensing of inside wiring, or have refused to follow either. In light of the concerns expressed about an efficiently functioning market, we must find that inconsistent depreciation rates prescribed by state commissions will interfere with the efficient operation of the communications marketplace and thereby frustrate the achievement of the Commission's policies. Accordingly, we find that this Commission's depreciation policies and rates, including the expensing of inside wiring, preempt inconsistent state depreciation policies and rates.

46. Accordingly, IT IS ORDERED, pursuant to Sections 1, 4(i), and 220(b) of the Communications Act of 1934, as

amended, 47 U.S.C. 151, 154(i), and 220(b), That the Petition for Reconsideration filed by the American Telephone and Telegraph Company IS GRANTED.

47. IT IS FURTHER ORDERED, That the Petition for Declaratory Ruling filed by General Telephone Company of Ohio IS GRANTED to the extent reflected herein.

48. IT IS FURTHER ORDERED, That the Secretary shall cause this order to be published in the Federal Register.

49. IT IS FURTHER ORDERED, That the Secretary shall cause a copy of this order to be served on each state commission.

FEDERAL COMMUNICATIONS COMMISSION[15]

WILLIAM J. TRICARICO,
Secretary.

Appendix A. Summary of Comments

1. AT&T argues that the Commission on reconsideration should find that state commissions are precluded from departing from the depreciation methods and rates established by this Commission in order to allow the carriers to achieve timely capital recovery. It views the *Preemption Order* as a retreat from the Commission's competitive policies.

2. AT&T asserts that realistic depreciation rates are essential to attain accurate cost-based pricing decisions to prevent artificial barriers to competition, to foster technological innovation which will enhance network efficiency and the availability of competitive alternatives, to facilitate the timely implementation of the detariffing of

[15] See attached separate statement of Commissioner Joseph R. Fogarty.

customer premises equipment[16] and to insure the financial viability of the carriers. It contends that competitive conditions result in faster obsolescence and shorter asset lives, requiring that depreciation methods and rates be inseparable from ratemaking to insure capital recovery.

3. AT&T proposes two legal theories for preempting state commission action. First, it asserts that the Commission may preempt under Sections 1 and 2 of the Act, citing *California v. FCC*, 567 F.2d 84, 86 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1010 (1978), *NCUC II*, *NCUC I*, and *NARUC v. FCC*, 533 F.2d 601 (D.C. Cir. 1976). It states that because of the central role depreciation, including the depreciation aspects of station connections, plays in the achievement of the Commission's policies, preemption is necessary to avoid interference with or frustration of these policies.

4. AT&T's second theory is that Section 220(b) preempts states on its face, asserting that in its earlier pleadings it did not rely on Section 220(g) as suggested by the Commission's decision. It argues that Section 220 gives the Commission discretion with respect to accounting rules, but does not give it such discretion with regard to depreciation prescriptions. AT&T states that the Commission's rule allowing carriers to subdivide an account to comply with a state commission order does not mean that a state can require capitalization when this commission requires expensing. Finally, it submits that the Commission misread the legislative history of the Communications Act by failing to consider statements in the committee reports and remarks of members at committee hearings that indicate Congress believed the Interstate Commerce Act provisions from which Section 220(b) was taken did in fact preempt the states. See also

[16] It contends that different depreciation rates between jurisdictions will result in disagreements about net book value in deregulating CPE and that the application of the Separations Manual will create uncertainty as to which plant a particular book value relates.

Depreciation Charges of Telephone Companies, 118 I.C.C. 295 (1926).

5. GTE asserts that the Commission's policies in the areas of competition and faster capital recovery will be frustrated if the state commissions are allowed to depart from the depreciation rates and methods prescribed by the Commission. It contends that Section 220(b) preempts the states and distinguishes Section 220(a) as being discretionary on the Commission and argues that the Commission focused only on the provisions of Section 220(a) in its earlier decision. It submits that there is no doubt that a state can require a carrier to keep additional records and memoranda. However, GTE argues that the Commission's decision is overly broad. It is clear, GTE contends, that the Commission can preempt inconsistent state action when it conflicts with national telecommunications policies, and it should do so in this case. GTE also argues that the legislative history and the rules of statutory construction indicate that Congress intended to preempt the states in the area of depreciation, submitting that property cannot be successfully depreciated at two different rates prescribed by different regulatory bodies because under or over recovery from one or the other jurisdiction will occur from the use of shifting usage factors.

6. The oppositions generally argue that the states have the jurisdiction to determine the extent to which intrastate rates reflect depreciation and expensing adjustments promulgated by the Commission. Sections 2(b) and 221(b) are cited as reserving jurisdiction over local and intrastate telephone rates to the states as intended by Congress when it distinguished between "interstate" and "intrastate" in Sections 1 and 2. Ohio argues that the preemption argument was rejected in the only case of which it is aware, *Pacific Telephone and Telegraph Company v. California*, 401 P.2d 353 (1965).

7. Ohio asserts that the courts have distinguished between ratemaking and interconnection policies, *NCUC*

II and *NCUC I*, and submits that it is the ratemaking jurisdiction reserved to the states that is in question in this proceeding. To permit the Commission to prescribe depreciation rates applicable to all property whether used for interstate or intrastate services would, in Ohio's view, be equivalent to giving the FCC a hand in setting state rates.

8. Ohio is concerned that under some methods, such as remaining life, costs will not be charged to consumers who receive the benefits of the property being depreciated. Finally, it contends that Sections 220(i) and (j) are consistent with concurrent jurisdiction.

9. Ohio argues that GTE is attempting to have the Commission read Section 2(b) out of the Act, and asserts that it is inappropriate to ignore language in a statute, to extend a statute beyond its clear import, or to embrace subjects not specifically enumerated. Section 2(b)(1) is stated by Ohio to have been intended to reverse the Supreme Court decision in *Houston East and West Texas Ry. v. U.S.*, 234 U.S. 342 (1914), wherein the ICC was given the power to suspend intrastate rates enabling carriers to raise intrastate rates to federal levels for similar distances. NARUC and Ohio argue that Section 2(b) was intended to ensure that state jurisdiction was not limited by the 1934 legislation.

10. Several parties assert that there is considerable Commission precedent recognizing the states' independent ratemaking authority, including departures from Commission prescribed accounting, for intrastate rates. They note that the Commission has encouraged state commissions to devote more resources to depreciation matters, *Amendment of Part 31*, 83 FCC2d 267 (1980) *recon.*, 87 FCC2d 916 (1981), has recognized in this proceeding the state jurisdiction over expensing of station connections for state ratemaking purposes, has recognized divergent treatment of interest during construction and has not contested California's use of remaining life for approximately thirty years. Ohio argues that there is nothing to suggest that there needs to be national uniformity in depreciation procedures and that local diversity is desirable, noting that even a GTE of Ohio witness in an Ohio rate case has indicated that local diversity in setting depreciation rates is preferable.

11. Ohio contends that *McDonnell Douglas Corp. v. General Telephone Company of California*, 594 F.2d 720 (9th Cir. 1979), recognized the validity of intrastate regulatory jurisdiction under the Act by finding that Congress in enacting Section 2(b) had intended to give states considerable power with respect to wire communications that are wholly intrastate in nature.

12. California argues that the Commission's refusal to preempt state power to prescribe depreciation rates for intrastate ratemaking purposes will not undermine the Commission's procompetitive policies or signal a retreat since many states have adopted policies that foster competition. AT&T's assertion that preemption must be exercised to promote procompetitive policies is rejected by NARUC as unsupported. It states that expensing of station connection costs can have no competitive effect because expensing is not the same as unbundling. Moreover, it contends that the Commission did not adopt remaining life and equal life group depreciation procedures to promote competition but, rather, to more properly time capital recovery and insure that any deficiency in past depreciation was adjusted. Finally, NARUC states that the speculative statements about the numbers of states that are not following the Commission's policies are inadequate to justify preempting state commission jurisdiction on the theory that federal policies are being frustrated.

13. NARUC argues that the attempted distinction of Section 220(a) from Section 220(b) on the basis that Section 220(b) is mandatory while Section 220(a) is discretionary does not address the question of the

preemptive effect of either section. It contends that neither reason nor case law provides support for asserting that preemption of state regulation of intrastate communications is automatic with respect to subject areas which the FCC must regulate on the interstate level. It further notes that the language of Section 220(b) does not differ significantly from that in Section 220(g) with respect to the effect of prescribed depreciation rates, accounts or records other than as prescribed by the Commission. NARUC states that the relationship between accounting and ratemaking is self evident and argues that state control over intrastate rates would have little vitality if state commissions were deprived of the power to disallow expenses and depreciation claimed by carriers. NARUC asserts that the fact that a proposed Section 220(j) that would have expressly reserved depreciation prescription powers to the states was not adopted does not mean that states must be bound by Commission depreciation prescriptions, stating that the final provision adopted was a compromise.

14. Consumers' Counsel supports the Commission's *Preemption Order* and generally cites from that *Order* in support of its position. Idaho also agrees with the conclusion of the Order and states that it believes that administrative costs of separate record keeping to meet state requirements will be small. Arkansas filed to indicate that its opinions had not rejected the new depreciation methods outright but had left the decision to individual cases for resolution.

15. AT&T's reply submits that the setting of depreciation rates does not constitute the exercise of jurisdiction with respect to charges for intrastate services. It argues that Section 2(b) does not deprive this Commission of jurisdiction over jointly used property where its regulation affects the conduct or development of interstate communications. AT&T states that if a state utilized the depreciation rate prescribed by the Commission, it may make adjustments to the test period data to reflect

concepts of used and useful property or other pro forma adjustments to reflect conditions during the period during which the tariff will be in effect.

16. AT&T distinguishes *Houston East and West Texas Ry. Co. v. U.S., supra,* by asserting that that case involved actual preemption of service rates. It notes that while Congress may have sought to reverse that decision in the communications field, the issue here is only the jurisdiction to prescribe depreciation rates. Thus, it contends that the case actually suggests that Section 2(b) should be narrowly interpreted. Moreover, while use of federally prescribed depreciation rates may significantly affect intrastate rates, the states remain free to price individual service rates. See *e.g., NCUC I.*

17. USITA submits that federal preemption of jurisdiction over depreciation rate prescriptions for carriers for which the Commission has prescribed depreciation rates would not interfere with state commission ability to set intrastate service rates in accordance with any ratemaking method desired. It contends that the setting of depreciation rates is not a ratemaking function pursuant to Sections 201-205, but is the exercise of a specific power granted to the Commission by Congress. USITA argues that divergent depreciation rates create confusion and raise problems of capital recovery.

18. GTE contends that state action whether in the nature of ratemaking or otherwise which "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" will be preempted. *Fidelity Federal Savings and Loan Association v. de la Cuesta,* 50 LW 4916, 4919 (1982). GTE concludes that the states do not have the power through the guise of ratemaking to negate FCC action designed to give effect to federal statutory objectives. GTE does not challenge state rights pursuant to state statutes to regulate rates for intrastate services. It asserts that no preclusion of state ratemaking jurisdiction would result from FCC pre-

emption under Section 220(b), although failure to preempt will endanger important national policies.

19. GTE submits that Section 220(b) charges the Commission with the responsibility of prescribing depreciation rates for carriers subject to the Act and recognizes only two exceptions. First, the Commission should act as soon as possible. Second, Section 220(h) recognizes that certain classes of carriers may be exempted. The Commission, according to GTE, has not exercised its authority pursuant to this provision in this proceeding. Finally, GTE argues that reliance on *NCUC I* and *NCUC II* as supporting a finding that the Commission cannot preempt state commission depreciation prescriptions for carriers subject to the Act is inconsistent with the holdings and analysis of those cases. AT&T and GTE submit that Section 221(b) is inapplicable because that provision was intended only to give states the jurisdiction to regulate local exchange service extending over a state boundary.

SEPARATE STATEMENT
OF
COMMISSIONER JOSEPH R. FOGARTY

In Re: Reconsideration of Docket No. CC 79-105.

Having dissented from the Commission's original decision declining to preempt State accounting and depreciation rules inconsistent with those prescribed by the FCC,[17] I am pleased that the Commission has reconsidered this issue and acted to preempt such inconsistent State regulation.

As this *Order* establishes in detail, a true reading of the statutory language and legislative history of Section 220(b) of the Communications Act clearly demonstrates

[17] Amendment of Part 31, Joint Dissenting Statement of Commissioners Joseph R. Fogarty and Anne P. Jones, 89 FCC2d 1109-1111 (1981).

that Congress intended FCC depreciation rules and policies to control the field.

Even if preemption were not explicitly mandated by Section 220(b), the effective implementation of our pro-competitive federal telecommunications policies dictates that inconsistent State depreciation regulation be preempted by this Commission. We cannot "defer to the States" on capital recovery issues. Telephone companies must be able to recover their costs of capital in a timely and effective manner if they are to price their services efficiently and to improve and expand their facilities to meet the challenges of competition and technologic innovation.

This preemption imperative is not merely theoretical. Too many States (e.g., Alabama, Louisiana, Nebraska, Ohio, New Jersey, Michigan, Arkansas) have already refused to recognize the critical necessity of the FCC's cost recovery principles. The resulting depreciation rate differentials are alarming: GTE of Ohio has indicated that it will be denied $7 million in capital recovery this year if the State of Ohio's disparate depreciation treatment is allowed to prevail.

The FCC cannot ignore the detrimental impacts of inconsistent State treatment of depreciation if our pro-competitive policies are to have any integrity and viability. This Commission now recognizes that preemption is both mandated as a matter of law and essential as a matter of policy, and our action today has my full endorsement and support.

ATTACHMENT B

Case No. 7661

Order No. 66114

In the Matter of the Application of the Chesapeake and Potomac Telephone Company of Maryland for Authority to Increase and Restructure its Schedule of Rates and Charges.

Before: Frank O. Heintz, William A. Badger, Lilo K. Schifter, Wayne B. Hamilton, and Haskell N. Arnold, Commissioners.

Issued: February 18, 1983

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APPEARANCES

J. William Sarver, D. Michael Stroud, Michael Morrissey, and Mark J. Mathis, for The Chesapeake and Potomac Telephone Company of Maryland.

James H. De Graffenreidt, Gregory V. Carmean, and Thomas C. Gorak, for the Office of People's Counsel.

Ronald A. Decker, and Bryan G. Moorhouse, for the Staff of the Public Service Commission of Maryland.

Varda N. Fink, for the State of Maryland, Department of General Services.

Robert R. Bair and John W. Hardwicke, for Maryland Industrial Group.

Harrison M. Robertson, Jr., for ADT Security Systems, et al.

Patsy Mullenix, for the General Services Administration.

Margaret Lee Quinn, Dennis K. Mancey, Dennis L. Myers, and David Worsley, for Telephone Answering Service Companies.

ORDER NO. 66114

Case No. 7661

In the Matter of the Application of The Chesapeake and Potomac Telephone Company of Maryland for Authority to Increase and Restructure its Schedule of Rates and Charges.

OPINION AND ORDER

Background

On July 26, 1982, The Chesapeake and Potomac Telephone Company of Maryland (hereinafter sometimes referred to as "C&P" or "Company") filed with the Commission an Application requesting authority to increase and restructure its schedule of rates and charges to become effective with service rendered on and after August 25, 1982. The revised rate schedules were designed to produce approximately $165,038,000 in additional gross annual revenues. During the proceedings the Company revised its request downward to $125,386,000, in order to reflect certain changed conditions.

By Order No. 65881, which was entered in this proceeding on July 29, 1982, the Public Service Commission of Maryland ("Commission") suspended the revised rate schedules for a period of 150 days from August 25, 1982, and instituted proceedings as to the justice and reasonableness of the proposed tariffs. Thereafter, by Order No. 66073, entered on January 4, 1983, the Commission extended the suspension period for an additional 30 days, for a total of 180 days, the maximum period authorized by law.

The Commission's Staff and The Office of People's Counsel ("OPC" or "People's Counsel") entered their respective appearances, and permission to intervene was granted to: the General Services Administration ("GSA"), Telephone Answering Service Customers ("TAS"); the State of Maryland, Department of General Services; the Maryland Industrial Group ("MIG"); and a number of companies intervening collectively as The Alarm Companies.

Testifying in support of the requested increases in rates were the following Company employees: J. Henry Butta, Vice President; David M. Gillis, Comptroller; Ethan Allen

Stenger, Division Manager — Programming; J. Lyman Anderson, Jr., Assistant Vice President — Costs and Economics Department; Joseph F. Agnich, District Staff Manager — Demand Analysis and Market Research; Ernest M. Sewell, Division Staff Manager — Corporate and Divestiture Plans; and Paul D. Kemp, Division Staff Manager — Regulatory Matters. Presenting additional testimony on behalf of C&P were: Thomas F. Clifford, Manager of Corporate Analysis in the Regulatory and Antitrust Matters Division of the Western Electric Company; Edward M. Dudley, Jr., Director — License Contract and Regulatory Matters at American Telephone & Telegraph Company ("AT&T"); Richard Walker, a certified public accountant with Arthur Anderson & Company; Hendrik S. Houthakker, the Henry Lee Professor of Economics at Harvard University; and Willard T. Carleton, and William R. Kenan, Jr., Professor of Business Administration at the University of North Carolina, Chapel Hill.

People's Counsel presented the testimony of Bruce M. Louiselle, Richard J. Lurito and Kenneth F. Gallagher of Kosh, Louiselle, Lurito & Associates; and John W. Wilson and Allen G. Buckalew of J. W. Wilson & Associates, Inc.

The Commission Staff presented Robert J. Henkes, Jamshed K. Madan and Richard J. Koda of the Georgetown Consulting Group; H. Joseph Ismail, the Commission's Chief Communications Engineer; and Sheldon Switzer, an economist in the Rate Research and Economics Division.

Several intervenors in these proceedings presented witnesses. The Maryland Industrial Group presented the testimony of Lee L. Selwyn, President, and Paul F. Levy, Senior Consultant, at Economics and Technology, Incorporated, and John J. Boland, Professor, Johns Hopkins University. Mark Langsam testified on behalf of the General Services Administration. Robert V. McNamara testified on behalf of the Telephone Answering Service

Customers. W. Kenneth Edward testified on behalf of The Alarm Companies. In addition, Lawrence H. Mitchell testified on behalf of the Attorney General for the State of Maryland.

In order to provide a convenient opportunity for customers of C&P to comment on the Company's Application, the commission advertised and held numerous public hearings throughout the Company's service territory.

The Commission has carefully considered all of the testimony, evidence, and argument which has been presented in this proceeding, and, in the discussion which follows, has resolved the various issues raised by the parties.

All parties agree that the 12-month period ending August 31, 1982 is the appropriate test year for use in this case. Since the parties have used this test period as the starting point in presenting their positions on the accounting issues, we find that the 12-month period ending August 31, 1982 is the appropriate test year for purposes of this proceeding.

I. Rate Base

All parties have presented average rate base calculations. The Company contends that its adjusted rate base averaged $1,515,769,000 over the test year; Staff presents an adjusted average rate base of $1,505,925,000; while People's Counsel maintains that it averaged $1,524,297,000. We now proceed to discuss and resolve the differences between the parties.

A. Accumulated Deferred Taxes.

Both C&P and Staff remove accumulated deferred taxes of $237,418,000 from the rate base, while People's Counsel decreases the rate base by $235,691,000 for this item. The difference between the parties occurs only because People's Counsel increases the ($237,418,000) amount by

$1,727,000 to reflect the amortization of deferred taxes resulting from the change in the Federal corporate income tax rate, while Staff and C&P reflect that item separately.

The adjustment for accumulated deferred taxes removes non-investor supplied capital from rate base; it is, therefore, an appropriate adjustment, as investors generally are not entitled to earn a return on capital which they have not provided. We will, therefore, accept Staff's and C&P's adjustment.

B. Reserve for Uncollectibles.

The record shows that each year C&P estimates the dollars in revenues which it should receive but will not receive during the upcoming year due to non-payment of telephone bills by its customers. C&P has followed this procedure for some undisclosed number of years. Company Exhibit 46 shows that a balance of $2,296,000 existed in the reserve for uncollectibles as of August 31, 1982, on a total Company basis. No figure for intrastate operations was supplied.

People's Counsel argues that the positive reserve balance demonstrates that C&P has overaccrued amounts from its ratepayers to cover billing amounts which it has written-off on its books. Mr. Louiselle expressed the opinion that the $2,296,000 represents customer, not investor, provided capital which is available to C&P for corporate purposes and on which investors should not be permitted to earn a return.

C&P responds by stating that the balance arises due to the delay (caused by collection efforts) in writing-off uncollectible accounts. According to Mr. Gillis:

> . . . The uncollectible reserve, however, provides no funds to the Company. Instead, it reflects the absence of a cash flow from current billings which will not be collected from customers in subsequent periods. After it has determined that the account is uncollectible, the write-offs or the charge to the

> reserve, will be made in subsequent periods. During the period from billing to write-offs, there are no funds available to the Company from this review. It is only the delay in writing-off these uncollectible accounts as collection efforts are pursued which causes the reserve balance; there has been no cash flow available to the Company.

In our opinion, C&P has not met its burden of proving that the facts support its position. Until such time as the Company can produce evidence showing that it is the continued lag in writing-off delinquent accounts which gives rise to the reserve, and that the reserve is not in excess of the amount of the continued lag, we will treat the amount in the reserve as customer, not investor, provided capital with respect to which C&P's investors are not entitled to a return.

As noted above, the reduction to rate base proposed by Mr. Louiselle is the amount in the reserve based on total Company operations. Since we are concerned solely with intrastate operations, it is inappropriate to deduct the full $2,296,000. Company Exhibit 46 shows test year accruals for uncollectibles on both a total Company, and an intrastate, basis. Applying the ratio between those two numbers (43.34 percent) to the total company reserve, we find it appropriate to deduct $995,086 from the rate base.

C. Expensing Station Connections.

C&P and Staff reduce rate base by $2,610,000 in conformance with this Commission's decision in *Re The Chesapeake and Potomac Telephone Company of Maryland,* Case No. 7591, Phase II, to employ a phase-in approach over a four-year period rather than a flash-cut solution in changing the accounting treatment for station connections. Since this adjustment is consistent with the corresponding adjustment to net operating income (see p. 22, *infra*), we find that C&P's rate base should be reduced by $2,610,000.

D. Western Electric Accounts Payable.

Staff Witness Henkes recommends that the Company's rate base be reduced by $15,930,000. This reflects the average test year payables (offset by the corresponding receivables) to Western Electric associated with capitalized purchases from Western Electric. The Company, as a part of its cash working capital calculation, reflects a reduction of $17,205,000 for the payment lag associated with the capitalized portion of Western Electric billings. This was offset by $1,075,000 to reflect the lag in receipt of Western Electric deferred taxes on such capitalized billings, for a net reduction of $16,130,000. People's Counsel did not make this adjustment.

Western Electric payables are a source of noninvestor supplied capital for the Company. As such, it is proper to remove this item from rate base since the Company is only entitled to a return on investor-supplied capital. The $15,930,000 adjustment proposed by Staff was computed in accordance with a similar adjustment which was accepted by the Commission in *Re The Chesapeake and Potomac Telephone Company of Maryland,* Case No. 7591, Order No. 65714, (March 24, 1982). For these reasons, the Commission finds Staff's adjustment to be appropriate, and it is accepted in this case.

E. Customer Deposits, Customer Advances, and Contractor Retentions.

The parties are in agreement that test year amounts for customer deposits $(5,134,000), customer advances $(1,379,000) and contractor retentions $(356,000) should be deducted from rate base. The Commission has viewed these items and concludes that the above deductions from rate base are appropriate, because they represent non-investor supplied capital on which investors are not entitled to a return. We state the amounts separately rather than include them in our discussion of cash working capital, below.

F. Cash Working Capital.

Calculations of the Company's cash working capital requirements were presented by Mr. Gillis, for C&P; Mr. Henkes, for Staff; and Mr. Louiselle, for People's Counsel. Preliminarily, we find that an allowance for working capital should be included in rate base to the extent that investors' cash funds are needed to pay for cash expenses prior to the receipt of revenues from customers. It is these funds on which the investor is entitled to a return. It is with this purpose in mind that the Commission has reviewed and analyzed the positions of the parties in order to determine the appropriate level of working capital to be included in the Company's rate base.

All parties are in agreement that C&P's materials and supplies balance averaged $16,299,000. As previously noted, we have dealt separately with customer deposits and advances, contractor retentions, and Western Electric Accounts Payable. Each of the above items shall be reflected outside of the cash-working capital discussion which follows.

Mr. Gillis develops C&P's cash working capital requirement through the use of what he called the "comprehensive" lead-lag method. He applies the revenue collection lag days to the average daily operating revenues and then applied the expense/tax payment lag to the average daily level of operating expenses and taxes. The difference represents cash working capital requirement. Unlike the other parties, C&P did not include the preferred dividend lag in its calculation. In computing its cash working capital calculation, the Company uses unadjusted "per books" dollar amounts. It should also be noted that the Company's computation of cash working capital reflects depreciation, deferred taxes, deferred Job Development Investment Tax Credits ("JDIC"), and common stock dividends. C&P calculates its cash working capital needs to be $53,921,000.

Mr. Louiselle computes the Company's cash working capital requirement through the use of a traditional lead-lag analysis. Mr. Louiselle relies on the various lag days provided by Mr. Gillis. The witness' recommendation is based upon the pro forma level of all of the Company's expenses. He also includes deductions reflecting the working capital effect of excise taxes, interest expense and preferred dividends. Mr. Louiselle determined that C&P requires $29,176,000 for cash working capital.

Mr. Henkes also computes the Company's cash working capital requirement by applying the net lag days to individual expense items. A difference between Mr. Henkes and Messrs. Louiselle and Gillis is that Mr. Henkes did not include a cash-on-hand balance in his working capital computation. Mr. Henkes has determined that C&P requires $30,131,000 for cash working capital.

In determining an appropriate allowance for cash working capital, the first issue raised concerns the methods used by the parties to calculate cash working capital. As previously mentioned, the Company proposes a new "comprehensive" lead-lag method. Both Staff and People's Counsel develop traditional lead-lag analysis. The method used by Staff and People's Counsel conforms to this Commission's previously stated preference for an itemized analysis of cash working capital needs. Through the use of an itemized analysis the relative timing of receipts and disbursements can be more accurately determined, and it is this relationship which gives rise to the need for cash working capital.

In our opinion, the Company's analysis reflects certain infirmities. The Company's computation of cash working capital reflects depreciation, deferred taxes, deferred JDIC and common stock dividends. In C&P's last case, Case No. 7591, we were quite clear in stating that we reject the inclusion of non-cash expenses because they do not create actual cash needs. In addition, the Commission stated therein that pro forma, rather than "per books," expenses

should be reflected in the computation of cash working capital. C&P's proposal in this case fails to use pro forma expense amounts.

Staff and People's Counsel both presented cash working capital studies in general conformance with this Commission's policies and practices. Aside from Mr. Louiselle's inclusion of an amount for cash-on-hand, which amount was not reflected by Mr. Henkes, the differences between Staff and People's Counsel generally can be ascribed to differences in their pro forma adjustments, and capital cost rates. In accordance with our decision in Case No. 7591, we will adopt a cash-working capital allowance consistent with Mr. Henkes' calculation. (See Appendix 1.)

G. Separation Changes: SPF, CPE.

The Company, Staff and People's Counsel all reduce C&P's net operating income by $639,000 for this adjustment, which accounts for the Federal Communications Commission's freeze on the value of the Subscriber Plant Factor and the phase-out of certain customer premises equipment from interstate operations. The Company and Staff also reduce rate base by $469,000 for this item; however, People's Counsel did not make this corresponding adjustment to rate base. The Commission has reviewed these proposed adjustments and accepts the rate base and income adjustments proposed by the Company and Staff.

H. Rate Base Findings.

Some adjustments to rate base will be discussed in the net operating income section of this Opinion, since the same adjustment may have both a rate base and income effect. In addition, another adjustment is discussed in the Computer Inquiry II section. After making the foregoing adjustments, we find that the fair value, for rate-making purposes, of C&P's intrastate property in rendering service to its customers averaged $1,505,988,000 during the 12-month period ended August 31, 1982. (See Appendix 2.)

A. Capital Recovery.

As in Case No. 7591, the Company proposes to cease use of the vintage group and whole life methods of depreciation and substitute depreciation rates for existing telephone plant based upon the remaining life method and for new outside plant and central office equipment based upon the equal life group method.

The Company asserts that the Federal Communications Commission's ("FCC") prescription of such rates requires their use for intrastate rate-making purposes. As authority for this proposition, the Company points to the recent Memorandum Opinion and Order of the FCC pre-empting State jurisdiction in this area,[18] as well as to certain other court decisions giving the FCC authority over aspects of the telecommunications' industry which have an effect intrastate.[19]

In addition, the Company maintains that even had the FCC not spoken, substantive reasons exist to justify the changes in methodologies. It is the Company's position that remaining life depreciation rates are required in order to allow C&P to recover the capital invested in Maryland telephone plant in its entirety and that equal life group depreciation rates are required to achieve an appropriate matching of capital recovery with capital consumption.

People's Counsel, MIG, and Staff vigorously oppose adoption of either the remaining life or equal life group methods of depreciation. Both OPC and Staff take issue with the FCC's authority to impose depreciation rates on

[18] Amendment of Part 31, CC. No. 79-105 (January 6, 1983).

[19] We are unpersuaded by the cases which the Company cites for the proposition that the courts have recognized the FCC's authority to pre-empt state commissions notwithstanding Section 2(b) of the Communications Act of 1934, 47 U.S.C. 152(b). These cases dealt with aspects of telephone service which are interstate by their very nature; e.g., FX/CCSA and interconnection policies.

state commissions where intrastate telephone service is involved. All three parties object to the changes due to the uncertainties surrounding C&P as a result of the upcoming divestiture. According to these parties, even if the proposed depreciation methodologies have theoretical advantages over the existing methodologies, in practice remaining life and equal life group depreciation will benefit the competitive (AT&T & American Bell, Inc.) subscriber and burden the monopoly (C&P) ratepayer.

Thus, two issues[20] regarding depreciation are presented for decision in this proceeding: 1) whether this Commission is empowered to adopt for intrastate rate-making purposes any depreciation rates other than those prescribed by the FCC; and 2) if the FCC's action does not limit this Commission, whether it should adopt the remaining life and equal life group methodologies.

We will address the threshold question first. It is settled that state commissions may establish depreciation rates (and therefore methodologies) in the absence of federally-prescribed rates.[21] However, the Supreme Court has expressly reserved judgment as to the effect on state commissions of depreciation rates prescribed by a Federal commission.[22]

All parties to this case, as well as the FCC, agree that the standard set forth in *Florida Lime and Avocado Growers v. Paul*[23] should govern the resolution of this issue. As in Case No. 7591, we continue to agree with this analysis. The *Avocado Growers* standard requires that there be either persuasive evidence that the nature of the subject matter permits no other conclusion than that state

[20] We extensively analyzed these same issues in Case No. 7591. By this opinion, we fully adopt our reasoning as expressed in the former proceeding.

[21] *Northwestern Bell Telephone Co. v. Nebraska State Ry. Commission,* 297 U.S. 471 (1936).

[22] *Id.* at 478.

[23] 373 U.S. 132 (1963).

regulatory power has been pre-empted, or that Congress has unmistakably ordained such pre-emption.[24]

The Company, by its reliance on the FCC pre-emption order, maintains that in the matter of Federal prescription of depreciation rates, both criteria are met.

With regard to the first aspect of the standard, the FCC advances the claim that state prescription of depreciation rates and methods would frustrate the Federal policy of making available ". . . so far as possible, to all people of the United States a rapid, efficient, nation-wide, world-wide, wire and radio communication service with adequate facilities at reasonable charges. . . ."[25] The FCC states that pre-emption is necessary to further the goal of affordable universal service. It reasons that competition is desirable in certain markets, that its depreciation methodologies will foster this Federal policy, and that proper price signals, generated by the dynamics of supply and demand, are necessary to encourage competition. Because most plant is used interchangeably to provide interstate and intrastate services, supply and demand for telephone products and services are determined by the combination of inputs from both state and Federal regulatory jurisdictions. Thus, the FCC states that any depreciation rates or methodologies at variance with those determined by the FCC could affect the efficiency of the market place by providing for less-than-adequate capital recovery by the regulated utility.[26]

Recognizing the deference to which the FCC is entitled in interpreting its own enabling legislation,[27] we cannot accept this analysis as a reasonable reading of its responsibility to provide universal service at reasonable rates.

[24] *Id.* at 142.

[25] Amendment of Part 31, *supra*, at 13.

[26] *Id.* at 12-16.

[27] *Griggs v. Duke Power Co.*, 401 U.S. 424, 433-434 (1971).

By the FCC's own admission, depreciation will affect the net book value of assets and thus the gain or loss[28] realized upon their transfer from the monopolistic state-regulated entity to the competitive entity. The FCC also acknowledges that depreciation is an important part of the revenue requirement of the state-regulated telephone companies; thus, depreciation rates are important in determining the prices at which services are offered. Nonetheless, the FCC asserts that placement of the monetary burden of fostering competitive services interstate on the non-causative captive intrastate ratepayer is justified by administrative ease and technological growth within the industry.[29] The FCC maintains that this shifting of an identifiable economic burden does not infringe on the states' authority to set rates.

To this Commission, this appears to go beyond the "Shreveport Doctrine".[30] The FCC would not merely raise intrastate rates so as to avoid unreasonable discrimination against interstate commerce. By its action the FCC would raise intrastate rates in order to lower interstate rates. This is not a result intended under the Communications Act of 1934 ("the Act").[31]

With regard to the FCC's assertion that its action does not infringe on the states' rate-making authority and need not affect rates, we note that ratemaking is more than the adoption of a tariff. Principles govern the return to which C&P is entitled and should the Company's expenses

[28] The record in this case is clear. For C&P adoption of these depreciation methodologies indicates a loss for the Company when the assets are transferred relative to what would be realized should current methodologies be retained.

[29] Amendment of Part 31, *supra*, at 14.

[30] *Houston, E. & W.T.R. Co. v. United States*, 234 U.S. 342 (1914).

[31] *North Carolina Utilities Commission v. FCC*, 552 F.2d 1036, 1047 (4th Cir.), *cert. den.*, 434 U.S. 874 (1977).

increase, the principles governing the return remain unchanged.[32]

We see no evidence, either in the FCC's order or elsewhere, that the rates established by this Commission for the limited services subject to our jurisdiction can frustrate the Federal goal of promoting competition in the long distance market. The rates we establish are intended to cover the costs associated with the services we regulate. Since these services differ from those which the FCC seeks to promote, we do not see any effect upon Federal policy as a result of rate-making decisions which are limited in scope to those services subject to state jurisdiction. Furthermore, we also note that the increase in rates for basic local services which would result from adoption of the revised depreciation practices may well serve to frustrate the Federal policy of promoting universal service.

As to the second standard under *Florida Avocado Growers*, the Company again, through its reliance on the FCC Pre-emption Order, cities statutory construction as well as legislative history for the proposition that Congress has unmistakably intended that the FCC pre-empt state commissions with regard to prescription of depreciation rates.

In its Order, the FCC maintains that Section 220(b) in combination with Sections 220(i) and 220(j) of the Act compels the conclusion that Federal pre-emption of the area was intended. In Case No. 7591, the Company raised an argument similar to the reasoning adopted by the FCC. In our Opinion in Case No. 7591, we noted that ". . . the absence of an express reservation of state authority does not unmistakably evidence a Congressional intention to pre-empt the field. Rather, the absence of an express and unambiguous limitation on state authority compels the

[32] *Federal Power Commission v. Hope Nat. Gas Co.*, 320 U.S. 591 (1944); *Bluefield W.W. & Improvement Co. v. Public Service Commission*, 262 U.S. 683 (1923).

conclusion that Federal pre-emption of the field was not intended.[33]

In that same order we discussed at length the legislative history advanced to support the claim that Congress intended the FCC to have exclusive authority over depreciation rates for both interstate and intrastate purposes. Neither our reasoning nor our conclusion that ". . . there is no indication in the legislative history of the Act, or in other provisions of the Act itself, that Congress intended such a result. . . ."[34] has changed. We note, however, that the FCC's earlier opinion stated that the legislative history on which it has now relied was "inconclusive."[35] Even in its latest opinion, the FCC finds the history to be "not dispositive"[36] (although leaning more towards than against a broad pre-emption position).

For these reasons, we conclude that the depreciation practices established by the FCC in no way limit this Commission's authority to independently determine the appropriate level of depreciation expense to be reflected in intrastate rates for telephone service.

We turn now to a consideration of the merits of the various methodologies proposed by the Company. It is C&P's position that the remaining life method is superior to the whole life method because it allows for constant readjusting of estimates of service lives thus dealing with the continuously changing conditions brought about by changes in technology and competition. The Company further maintains that equal life group ("ELG") is a superior method to vintage group because it: (1) more closely fits the cost allocation to the period of benefit; (2) it does not create large shortfalls in depreciation of the

[33] *Re The Chesapeake and Potomac Telephone Company of Maryland*, Case No. 7591, Order No. 65714 (March 24, 1982), p. 26.

[34] *Id.* at 28.

[35] Amendment of Part 31, *supra* at 6.

[36] *Id.* at 7.

less-than-average-life property to be made up by extra depreciation of the longer-than-average-life property in the group, and; (3) being more accurate as time passes, it can more readily accommodate large changes in technology as there is less likelihood of large accumulations of under-depreciation.

People's Counsel, through Mr. Louiselle, does not quarrel with the theory underlying the depreciation methodologies. Rather it is his position that absent a need for an infusion of internally generated capital or a seriously deficient reserve for depreciation — which situations he stated do not apply to C&P — a change to such methodologies is unjustified in light of the recently represcribed whole life rates and the impending divestiture. On brief, People's Counsel emphasized that any remaining life depreciation changes implemented will relate primarily to plant that C&P will transfer to American Bell, Inc. ("ABI"); accordingly, C&P's goal of matching vintage year customers will not be realized by C&P ratepayers. With regard to ELG, People's Counsel noted on brief that technological change should not be reflected in rates before that change occurs. According to People's Counsel, to do so violates the capital consumption theory proposed by the Company. In sum, it is the position of People's Counsel that the benefits of the proposed depreciation methodologies will not materialize while the costs to ratepayers will be significant.

Staff's Witness Madan objected to adoption of remaining life depreciation on the ground that the effect of adopting such a method is to lower the net value of assets to which it applies, thus increasing the revenue requirement to be paid by C&P ratepayers now and decreasing the amount to be received from AT&T at divestiture. On brief, Staff highlighted Mr. Walker's concession on cross-examination that remaining life and equal life group are superior depreciation methodologies only if the lives are accurate — the estimation of those lives being a process in which there is room for error.

Testifying for MIG, Paul F. Levy stated that ". . . [f]or the purposes of this proceeding, the [anti-trust] settlement removes the capital recovery problem as a *rate-making* issue for the terminal equipment and other assets to be transferred to AT&T at the time of divestiture." According to Mr. Levy, since C&P will receive full recovery of its invested capital at the time of divestiture, the Commission's primary concern should be the effect of the various depreciation proposals on the existing general body of ratepayers. On brief, MIG pointed out that as a result of represcribed whole life rates in Case No. 7591, C&P has implemented substantial increases in depreciation charges. MIG notes that: (1) the burden to current ratepayers of higher appreciation accruals in the early years occasioned by remaining life and equal life group techniques will not (because of divestiture) be offset by the benefit of smaller accruals charged the ratepayers in the later years; (2) remaining lives and group lives are merely negotiated estimates which are set once every three years; should these estimates result in underrecovery due to error, the net undepreciated investment is still on the books and the investor is still treated fairly by receipt of a fair return, whereas there is no provision to reimburse the current ratepayer upon any overrecovery due to erroneous estimates and upon divestiture and transfer of assets; (3) increased depreciation rates due to shortened lives will increase customer migration to the Flagship products being marketed by ABI, and; (4) that C&P's depreciation proposals are part of an AT&T program to increase internally generated capital to support AT&T's competitive operations.

In Case No. 7591, we stated our rationale for rejecting the remaining life and equal life group methods of depreciation as follows:

> . . . there is no compelling need to change depreciation practices in this proceeding in such a way as to accelerate the recovery of capital. Given the impending restructuring of the telephone industry, the relationship between AT&T's base

> migration strategy and its capital recovery proposals, and the lack of a demonstrated superiority of those proposals, we find that the Company's test year depreciation expense should not be adjusted to reflect the effect of revised depreciation methodologies.

We find the reasoning even more valid in this proceeding than it was in Case No. 7591.

No party to this proceeding would disagree that this is a unique period for the telecommunications industry. A decision to adopt the depreciation proposals advanced by the Company cannot rest solely on an analysis of the purported merits of those proposals, since divestiture will substantially affect the actual impact of the alternative depreciation methods. The remaining life method is intended to apply primarily to terminal equipment; i.e., equipment which will be transferred from C&P by 1984. Acceptance of the remaining life proposal would not only support AT&T's base migration strategy but would burden present C&P ratepayers in exchange for a benefit which they could not receive from the Company in the future.

The equal life group method of depreciation appears to offer a more accurate method to evaluate service lives. However, we cannot evaluate this or the remaining life proposal in isolation from the effect of the restructuring of AT&T. For these reasons, we reject the Company's proposals to adopt remaining life and equal life group depreciation. Accordingly, no adjustments will be made to rate base or net operating income for these items.

B. Expensing Station Connections.

In Case No. 7591, we ordered C&P to begin expensing station connection costs. In Phase I of that proceeding, we reflected in rates the first phase of a four-year phase-in period. Thus, 25 percent of station connection costs were expensed, and the remaining 75 percent were capitalized. Subsequently, use of the phase-in approach was reaffirmed in Phase II of Case No. 7591.

In this proceeding, C&P and People's Counsel decrease net operating income by $10,302,000 in conformance with the continuing process to expense, rather than capitalize, increasingly greater portions of station connection costs. Their adjustments are consistent with our actions in Case No. 7591, Phase II. It is the position of Staff, however, to flow through the accumulated unamortized investment tax credits associated with capitalized station connections over a three-year period rather than the ten-year period previously authorized. Accordingly, Staff reduced test year income by $6,305,000.

We find that the tax credits should be returned to ratepayers at the same rate over which the capitalized costs are amortized (a 10-year period). Accordingly, we accept the Company's and People's Counsel's adjustment.

C. Wage, Salary and Benefit Increases.

1. Wage and Salary Increases

The Company makes a three-part adjustment to test year operating expenses to annualize three wage and salary increases. The first part of the adjustment reflects the portions of the various annual expenses, not included in the test year, for the monthly salary increases effective prior to September 1982 and the general wage increase effective in August 1982. The general wage increase effective in August 1982 has occurred pursuant to the provisions of the 1980 General Agreement with the Communications Workers of America. The second part reflects the full impact of the January 1983 increases in pensions and vision care allowances negotiated as part of the 1980 General Agreement, and the increases in salary expense effective during the period September 1982 thru February 1983. The third part reflects the portions of the salary expense increases effective March 1983 thru February 1984, and wage expense increases effective August 1983 which will be realized during the first year of new rates. In sum, C&P is requesting all wage and salary increases through February 1984, which will be the entire first year revised rates would be in effect.

Staff recommends that if C&P's pro forma wage and salary adjustments are accepted by this Commission, it is appropriate that they be offset by a labor productivity increase of 2.5 percent.

People's Counsel presents the Commission with two alternative positions with respect to this issue of wage and salary increases. The first alternative is for the Commission to reject all wage and salary increases after December 31, 1982 due to the uncertainty of the impact Computer Inquiry II ("CI-II") will have on the Company's operations. The other alternative presented by People's Counsel Witness Louiselle, is to include the pre-August 1983 contracted-for wage and salary increases along with a CI-II adjustment specifically developed by Mr. Louiselle.

After careful consideration of this matter, the Commission concludes that the adjustments for wage and salary increases proposed by C&P — excepting the August 1983 wage increase — should be accepted. Accordingly, net operating income will be decreased by $15,612,000 to reflect the total of these adjustments.

In making this determination, the Commission is mindful of its following statement in C&P's last base rate case:

> . . . it is reasonable to reflect wage and salary expense incurred by the Company during the first year revised rates are in effect.

In reaching that conclusion, however, we made it quite clear that the crucial aspect of the issue concerning pro forma wage and salary expense increases is "whether the adjustment provides a fair representation of conditions as they will exist during a reasonable future period." Under the present circumstances, with the limited information available as to the full impact of CI-II and divestiture on Company operations, as well as the unknown effect of the present economic conditions upon wage negotiations, we cannot find at this time that the Company's August 1983 wage increase adjustment provides a fair representation of conditions as they will exist during the future.

With regard to Mr. Madan's labor productivity offset, we have rejected making such an adjustment in the last two C&P cases because of our concern that to do so would have exacerbated the problem of the Company failing to earn its authorized rate of return. Given the fact that the record reflects that the Company has failed once again to earn its authorized rate of return and in view of the uncertainties of the full impact of CI-II and divestiture, we conclude such an adjustment is not appropriate at this time.

2. Benefit Plan Changes.

The Company makes an adjustment to annualize Benefit Plan Changes taking effect in January of 1982. Staff makes a similar adjustment which differs only because it includes a labor productivity offset. In People's Counsel's adjustment Mr. Louiselle removes the effect of a refund of insurance premiums booked in the test year although paid in the prior year. Mr. Louiselle states his belief that since these premiums were collected from customers, it is they who should receive the benefit of the refund.

The record reflects that the refunds resulted because of a change in insurance carriers by the Company. Premiums paid to the original insurance carrier to pay future employee claims were refunded when the insurance carrier was replaced by another. We agree with the Company that since this is an event which will not be repeated when new rates are in effect, and since the Company failed to realize its authorized rate of return at the time the refunds were made, such an adjustment should not be accepted. Accordingly, we will accept the Company's adjustment reducing net operating income by the amount of $1,747,000.

D. Payroll Tax Changes.

The Company makes an adjustment to decrease net operating income by $231,000 to reflect changes in State, local and other taxes. Consistent with his adjustment to wages, Mr. Louiselle only reflects in his adjustment those increases as they affect 1982 expenses. Staff Witness Henkes' adjustment decreasing net operating income by $280,000 differs from the Company in that he took into consideration the actual changes in social security base and Federal unemployment rates which became effective January 1, 1983. The Company estimates the impact of those changes.

Since Mr. Henkes' adjustment reflects the actual changes, it will be accepted.

E. Amortization of Surplus Deferred Federal Income Tax ("DFIT").

The Company's reserve for deferred Federal income taxes was accrued at the statutory Federal income tax rate of 48 percent. Effective January 1, 1979, this rate was reduced to 46 percent. As a result of this reduction in the tax rate, the Company's accumulated provision for deferred income taxes exceeded its ultimate tax liability by $5,757,000. In Case No. 7591, we concluded that an amortization of the surplus over a five-year period was appropriate.

People's Counsel makes an adjustment increasing net operating income by $1,151,000 to reflect a five-year amortization of this excess deferred tax.

Staff is in accord with the Commission's policy of accelerated flow back of the excess deferred tax; however, Mr. Henkes avers that additional facts exist which were not available when Case No. 7591 was decided. Mr. Henkes testified that because of the spin-off and transfer of assets to AT&T, there is a possibility that C&P ratepayers will not receive the entire surplus amounts that they have paid to the Company. To the extent that

assets are transferred to AT&T, either under Computer Inquiry II or under the Divestiture Consent Decree, the associated excess deferred tax will be transferred with the asset. To avoid this result, Staff recommends amortizing the existing unamortized excess tax balance over a period of one and one-half years. Thus, Staff's adjustment to the test year net operating income, amounts to $2,913,000.

The Company requests that this Commission reconsider our decision in Case No. 7591 on this issue, therefore no adjustment to net operating income is made by C&P.

Upon reconsideration of this matter, we conclude that the adjustment proposed by Staff is appropriate. An amortization period of one and one-half years will negate the possibility of ratepayers not receiving the entire unamortized balance. The adjustment proposed by Staff, increasing net operating income by $2,913,000, is, therefore, accepted.

A concomitant adjustment to rate base is necessary to reflect the pro forma reduction in the Company's deferred tax balance resulting from the operating income adjustment to amortize the Company's excess deferred taxes over a one and one-half year period. The Commission finds it appropriate to accept Staff's adjustment and will, therefore, increase rate base by $2,608,000.

F. Tax Effect of Pro Forma Interest.

The Company, Staff and People's Counsel each make an adjustment to operating income to synchronize the interest expense implicit in the authorized rate of return with that used in computing test year income taxes. Each of the parties' adjustments differ, however, because of their reliance on their own rate of return and rate base recommendations. Additionally the Company's adjustment differs in that it identifies unamortized Job Development Investment Tax Credits as a separate and distinct part of the capital structure used in determining the cost of capital.

The Company's adjustment as it relates to the investment tax credits has been rejected by this Commission in the Company's last two rate cases. See *Re The Chesapeake and Potomac Telephone Company of Maryland,* Case No. 7467, Order No. 65112, (Md. Pub. Serv. Comm'n, January 29, 1981), and *Re The Chesapeake and Potomac Telephone Company of Maryland,* Case No. 7591, Order No. 65714, (Md. Pub. Serv. Comm'n, March 24, 1982). The Staff and People's Counsel propose the methodology which this Commission has consistently used to determine the pro forma interest adjustment. Based on the record in this case as well as our decisions in the prior two C&P cases on this issue we once again decline to accept C&P's proposed adjustment.

Accordingly, the adjustment proposed by Staff and People's Counsel will be adopted whereby the Company's test year income taxes will be adjusted to reflect the level of interest expense included in the return.

G. Interest During Construction.

Consistent with past Commission policy, the Company, Staff and People's Counsel recommend that interest during construction ("IDC") accrued during the test year on both long- and short-term Plant Under Construction be reflected as an offset to the cost of service for rate-making purposes. Accordingly, each of the parties make pro forma adjustments, consistent with the Commission Order in Case No. 7335, to reflect IDC on short-term Plant Under Construction which is accrued off books by the Company. The Staff's adjustment is identical to the Company's. People's Counsel, however, proposes further to adjust test year IDC downward to reflect an accrual rate of 11.61, consistent with the rate of return recommended by Dr. Lurito. Mr. Louiselle testified that the cost of capital for construction should be the same as the cost of any other capital and he, therefore, contends that long-term and short-term IDC should be reflected at the rate of return authorized in this proceeding.

Having considered this matter, the Commission prefers the use of test-year data, rather than a pro forma adjustment. Accordingly, and in view of our rate of return determination, we will accept the adjustment as proposed by Company and Staff thereby increasing net operating income by $3,289,000.

H. Expensing of Minor Purchases.

The Company and Staff propose an adjustment to decrease net operating income reflecting the impact of the change from $50 to $200 in the limitation for expensing minor items such as small tools and office equipment.

People's Counsel takes exception with that portion of the Company's and Staff's adjustment which pertains to minor items, costing more than $50 but less than $200, which were purchased in the recent past. The Company and the Staff proposed to amortize the capitalized cost of these items. People's Counsel Witness Louiselle believes that to allow this portion of the adjustment would be retroactive rate making.

Having considered the evidence presented on this matter, we conclude that the adjustment in the amount of $489,000 as proposed by the Company and Staff is appropriate.

I. Reorganization.

The Company proposes an adjustment to increase net operating income to reflect savings from C&P's management reorganization. In Staff's adjustment, Mr. Henkes uses flash-cut expensing and does not revise his adjustment as a result of the phase-in ordered in Phase II of Case No. 7591. People's Counsel, consistent with its wage related adjustments, reflects only those savings to be experienced through December 31, 1982.

After considering the evidence presented on this matter, we accept the adjustment proposed by the Company and accordingly increase net operating income by $1,380,000.

J. Removal of Out-of-Period License Contract.

All parties agree that an adjustment should be made to test period operating income to reflect reimbursement for out-of-period General Service and License ("GS&L") expenses. However, the parties differ as to the amount of that adjustment. The refunds which were booked in October and December 1981 as credits to GS&L expense relate to costs incurred by the Company for the period March through August 1981. The Company would remove from operating income $338,000, the entire out-of-period booking, for the simple reason that the credits are related to expenses incurred outside the test period. Staff has accepted the Company's adjustment.

People's Counsel, however, asserts that only $27,000, the amount booked in December 1981, should be deducted from operating income. According to OPC's Witness Louiselle, this booking represents typical "on-going true-ups" the removal of which from net operating income is consistent with past Commission approved treatment. Mr. Louiselle maintains that the amount booked by the Company for this item in October reflects a refund of License Contract costs paid by C&P relating to AT&T General Department Activities incurred in the formation of American Bell Incorporated ("ABI").

We agree with People's Counsel that since the Company has attempted to relieve its ratepayers of ABI-related costs, consistency requires that refunds such as this one be returned to ratepayers. The Company failed to respond either in rebuttal testimony, on brief, or at oral argument to Mr. Louiselle's characterization of the October booking. For this reason, we will accept OPC's adjustment and will decrease operating income by $27,000 to account for retroactive license contract billings.

While the refund in question was received during the test year in this case, the record indicates that subsequent to the close of the test year C&P has received and expects to receive in the future additional License Contract

refunds from AT&T for ABI-related expenses. The intrastate portion of ABI-related expense reimbursements received on December 12, 1982 is estimated by the Company at $4,957,651. According to the Company, only $1,527,474 of that amount is applicable to the test period in this case and has been included in the CI-II adjustment. These and other refunds will be considered in our future determination as to what extent the License Contract costs which were deferred in this and the prior case should be amortized to the services remaining with C&P after divestiture.

K. License Contract Fees.

The reasonableness of the License Contract fees for ratemaking is at issue in this proceeding, as it was in C&P's last several rate cases. In this proceeding, however, we are faced with two additional inquiries. First, to what extent will the License Contract fees which were charged to C&P during the test year be representative of License Contract fees which will be billed to C&P during the rate-effective period? Secondly, to what extent will the fees constitute compensation for services provided under the Contract which will benefit the Maryland ratepayers?

In recognition by AT&T that those License Contract fees which were incurred in the formation or for the benefit of American Bell, Inc. should not be charged to the Maryland intrastate ratepayers, C&P has received and is expected to receive refunds from AT&T for License Contract expense related to the test year License Contract billings. While certain test year related refunds appropriately have been accounted for in the Subsidiary Formation and CI-II adjustments, the level of License Contract fees or the services provided during the rate effective period which encompasses the remaining months in the life of the License Contract Agreement, is less than known and certain.

In C&P's last rate proceeding, Case No. 7591, we excluded from intrastate test year expense certain License

Contract items. Specifically, we excluded charges associated with the Department of Justice's antitrust suit, charges primarily related to holding company activities, and 40 percent of the research and systems engineering expense allocated to C&P's intrastate operations.

In this proceeding, as in the past, C&P claims it has demonstrated that its License Contract Expense is reasonable, that it has fully adjusted its License Contract expense to reflect the impact of CI-II and that any disallowances of License Contract expenses due to divestiture would be inappropriate. Furthermore, C&P argues again that research and systems engineering funded by the License Contract is not product related and should not be disallowed.

People's Counsel proposes two alternative approaches for handling License Contract fees. The first approach, which is the preferred position of People's Counsel, was presented by Mr. Buckalew. He recommends that C&P be limited to paying only 1 percent of its revenues (less uncollectibles) to AT&T for its share of license contract expenses instead of the current ceiling of 2.5 percent. People's Counsel contends that this constraint is critical during the current transitional period to protect Maryland ratepayers from bearing part of the cost of financing AT&T's competitive endeavors. As an alternative approach, People's Counsel Witness Louiselle presents adjustments to net operating income which reflect the Commission's disposition of the License Contract fees in Case No. 7591. That is, he removes from test year expenses charges associated with the Department of Justice's antitrust suit and 40 percent of the research and systems engineering expenses ("R&SE") allocated to C&P's intrastate operations (while capitalizing the remaining 60 percent as an addition to rate base).

MIG Witness Levy proposes a "middle ground" between total acceptance and total disallowance by this Commission of all Affiliated Interest expense. Mr. Levy testified

that license contract, business information systems, conduit billing and cost sharing are funded, in large part, currently and by ratepayers. Given the fact divestiture means that AT&T will benefit from the activities funded by these sources (and that C&P will no longer benefit), he states that ratepayers should no longer pay for this work, unless C&P provides an accounting of these costs showing the benefits to (a) the ratepayers, and (b) the stockholders. In the alternative, he suggests that C&P maintain a separate account, similar to a CWIP account, in which Affiliated Interest charges would accumulate. Carrying charges, similar to AFUDC, would also accumulate. An allocation of the costs in this account could be made once the reorganization plans are known with more certainty.

Staff Witness Koda recommends several disallowances and deferrals based upon his investigation and analysis of the work activities underlying the various License Contract charges. Mr. Koda relies heavily upon Budget Decision Packages ("BDP's") which he testified are the only documents which provide disaggregated cost data for specific activities undertaken by the General Department of AT&T. Specifically, Mr. Koda recommends the following adjustments to the Company's License Contract Fees: (1) disallow $225,000 pertaining to parent related costs; (2) disallow $187,000 of expenses arising from activities that benefit the fully separated subsidiary; (3) disallow $586,000 of expenses which are of little or no benefit to Maryland ratepayers, that is specifically, the Department of Justice antitrust suit and the New York State Franchise Tax; (4) disallow $2,570,000 or 36.7 percent of all R&SE expenses allocated to C&P which primarily benefit product manufacturers and non-regulated Bell entities; (5) capitalize and amortize (over 10 years) that portion of R&SE expenses not disallowed rather than expensing them on a current basis. Finally, Mr. Koda recommends an adjustment for non-License allocations and general exclusion in the amount of $1,042,000. In sum, Mr. Koda's various adjustments to the

Company's License contract fees results in a net-of-tax increase of $3,362,000 to net operating income.

Also, in addition to Mr. Koda's recommendations, Staff Witness Henkes presents a separate adjustment in the amount of $98,000 to reflect an exclusion from test year operating expenses the Company's allocated share of AT&T's corporate-informative advertising. Staff's position is that such advertising does not result in a direct benefit to Maryland ratepayers. This contention was not rebutted by the Company.

As noted above, in C&P's last rate case we excluded License Contract charges associated with the antitrust suit and parent Company activities as well as General Department expenses assignable to the fully separated subsidiary, as recommended by Mr. Koda. In that proceeding, as well as previous proceedings, we noted that we have rejected the Company's contention that the type of evidence which it has presented establishes the reasonableness and prudence of *all* expenditures incurred under the License Contract. We reject that contention once again as it relates to all those expenses recommended for disallowance by Staff Witnesses Koda and Henkes. Our review of the evidence convinces us that the underlying activities associated with these expenditures are of such a nature that they should not be borne by this State's ratepayers. Thus, Messrs. Koda's and Henkes' adjustments of $3,362,000 and $98,000, respectively, shall be accepted.

In Case No. 7591, we determined that 40 percent of the R&SE expense which was allocated to C&P through the License Contract should be disallowed as an expense for intrastate rate making and be allocated to Western Electric and activities which will benefit the newly formed subsidiary.

Mr. Louiselle supports continuation of disallowance of 40 percent. Mr. Koda, based on his analysis of the BDP's, recommends in this case that a minimum of 36.7 percent

of R&SE expense should be disallowed. We shall continue our policy of excluding a portion of R&SE expense which represents that portion of the expense that benefits product manufactures and non-regulated Bell entities. Accordingly, we will disallow 36.7 percent of R&SE expense as proposed by Mr. Koda since his analysis reflects the most updated information available.

With respect to the remaining 63.3 percent of R&SE expenses, in Case No. 7591, the Commission determined that in light of the impending restructuring of the Bell System, these costs should be deferred and included in rate base in order to provide a return pending final disposition.

As we stated in Case No. 7591:

> Deferral of the recovery through capitalization and amortization will enable the Commission to defer a ruling on the ultimate disposition of this expense to a point in time when the restructuring may more clearly indicate the appropriate treatment. Thus, the future course of events may result in exclusion of this expense, its rapid recovery, or a continuation of the treatment adopted herein.

Thus, while we authorize capitalization and one year's amortization of previously deferred R&SE expense for inclusion in test year results in this case, we will examine in future cases to what extent the deferred License Contract fees should be fully amortized to the services remaining with C&P, or to what extent these items should be transferred from C&P at the time of divestiture. Accordingly, with respect to our decision in this case, rate base shall be adjusted by $3,546,000 to reflect the proper amount of R&SE to be capitalized net of deferred tax.

L. Business Information Systems ("BIS").

The inclusion of Business Information Systems expenditures in the Company's cost of service is at issue in this proceeding. As in past proceedings, Mr. Butta testified

with regard to this program and the Company's participation. As he has noted in the past, Mr. Butta explained that these Business Information Systems are computer software programs developed by Bell Labs for C&P and other participating operating telephone companies, to control operating costs and capital expenditures, improve customer service, enhance plant utilization, automate business records, and provide information necessary for effective management. Mr. Butta further notes that without central development through Bell Labs, of these Business Information Systems, C&P would have to incur the significant additional cost of hiring a substantial number of computer programmers to develop this software.

People's Counsel's Witness Louiselle recommends that all BIS expenditures be removed from operating expenses and capitalized subject to a 10-year amortization. He also recommends that the capitalized portion be reflected in rate base, net of deferred taxes to enable the Company to earn a return on the BIS expenditures. Mr. Louiselle explained that the purpose of his adjustment is to allow the commission flexibility to assess the benefits of the BIS projects at a future time. In this way, ratepayers will be relieved from funding BIS projects in which they receive little or no benefit and consequently be charged only for those costs which do benefit them. Mr. Louiselle's concern that some BIS projects may not benefit Maryland ratepayers arises out of the creation of ABI and divestiture. The witness expresses his belief that many systems currently funded by C&P may provide substantial benefit only to ABI or AT&T.

Staff Witness Koda likewise testified that certain BIS projects currently being charged to C&P have not been implemented in the Bell System while still others have been available for some time but never implemented by C&P. Accordingly, Staff recommends that costs for those BIS projects identified by Mr. Koda which will not be used should be disallowed from the Company's revenue re-

quirement. Also, those costs associated with the BIS projects identified by Mr. Koda that will be used sometime in the future should be deferred until put in service and then amortized for 10 years. Additionally, Mr. Koda recommends that certain BIS systems relating to customer premises equipment for businesses should be disallowed in view of the limitations upon C&P resulting from the CI-II decision effective January 1, 1983.

Although the Commission has allowed C&P to fully expense all BIS projects, in Case No. 7467 we noted our concern with the rapid growth of these expenditures and stated that we would closely scrutinize both the amount and purpose of such expenditures in the future. While we agree with the Company's basic position that BIS projects in general are beneficial to C&P and its ratepayers, the Company has nevertheless failed to rebut the contentions raised by People's Counsel and Staff regarding specific BIS projects that will be of little or no benefit to C&P and its Maryland ratepayers.

Accordingly, after consideration of the evidence and arguments presented with regard to this issue, we find that all those specific BIS projects identified by Mr. Koda either for disallowance or deferral should be removed from operating expenses and capitalized net of deferred taxes. In future cases, we will reexamine these deferred BIS expenditures to determine to what extent they should be fully amortized to the services remaining with C&P, or to what extent these items should be transferred from C&P at the time of divestiture.

Thus net operating income will be increased by $605,000 and the corresponding adjustment will increase rate base by the same amount.

M. Conduit and Cost Sharing Charges.

Unlike the License Contract, participation in a Cost Sharing Agreement by a specific Bell Operating Company such as C&P is left to the discretion of the operating

company. The Conduit Arrangement covers third party or vendor services, such as insurance and advertising, which are purchased centrally by AT&T for operating companies.

Staff Witness Koda, upon analyzing cost sharing and conduit charges paid to AT&T by C&P, concludes that certain charges should be removed from C&P's cost of service because they will inure to the benefit of AT&T's unregulated entities. On brief, People's Counsel supports Mr. Koda's adjustments on this issue.

Essentially, Mr. Koda proposes disallowing the costs of projects pertaining to marketing of ABI products and activities which focus on maintaining or improving AT&T's corporate image. In recognizing that C&P will receive some benefit from AT&T's national advertising geared towards improving its image and achieving overall communications awareness, Mr. Koda proposes disallowing only 50 percent of these charges.

The record reflects that the Company did not rebut the proposed Conduit and Cost Sharing adjustments of Mr. Koda. After considering the evidence on the record with respect to this matter, we conclude that Mr. Koda's disallowance adjustments in the amount of $734,000 should be accepted.

N. Subsidiary Formation Costs.

The Company, Staff and People's Counsel concur that test year intrastate results should be adjusted so that those Company expenses which are related to activities associated with CI-II and incurred during the test year are removed. Removal of these expenses for rate-making purposes is consistent with the treatment accorded them in Case No. 7591. For this reason, C&P credited $601,000 to operating income to reflect the cost of subsidiary formation and enhanced services. Staff accepted the Company's adjustment. People's Counsel only reflected $223,000 as subsidiary formation costs.

It appears, however, that the major portion of the difference for this adjustment between OPC and the Company and Staff is included in Mr. Louiselle's "License Contract Disallowance R&SE Net" calculation. We will accept the adjustment as proposed and reflected by the Company and Staff.

O. Net Operating Income Findings

After making all the aforementioned adjustments, and, including those adjustments which impact upon net operating income and were made under the Rate Base and Computer Inquiry-II sections of this Opinion and Order, the Commission finds that C&P's adjusted net operating income was $161,977,000 for the 12-month period ended August 31, 1982. (See Appendix 3.)

III. Computer Inquiry II

A. Introduction.

As was noted in our Order No. 65714 in Case No. 7591, the Federal Communications Commission ("FCC") has been conducting proceedings in a case known as the *Second Computer Inquiry* ("CI-II"). The CI-II decisions made by the FCC provide that on and after January 1, 1983, the Bell System may market new customer premises equipment ("CPE") only on a detariffed basis, and only through the newly-formed, fully separated subsidiary, American Bell, Inc. Accordingly, on and after January 1, 1983, C&P may not market new CPE under the Bell System umbrella.

CI-II further provides that C&P may market and provide embedded CPE during 1983 on a tariffed basis. Under the terms of CI-II, embedded CPE is that which is in service or in C&P's inventory on December 31, 1982.

Rules established by the FCC further provide that ABI may contract for C&P's services in installing CPE for complex business systems sold or leased by ABI in 1983; C&P would be reimbursed for its direct expenses under

any such contract. Finally, it should be noted that C&P assisted in the "creation" of ABI by transferring some of its employees and Phone Center outlets to the new entity. Several parties commented on these aspects of CI-II; they will be discussed shortly.

In recognition of the impact that CI-II will have on C&P's operations, the Company and Staff propose adjustments to the historic test year in order to reflect estimates of the CI-II impact. While Mr. Louiselle also computes a CI-II adjustment, People's Counsel recommends that the Commission recognize the infirmities of any such adjustment and, as previously noted, respond to this state of uncertainty by not giving effect to wage, salary and benefit increases past December 31, 1982, as the sole means of adjusting C&P's operations for the effect of CI-II. Mr. Louiselle points to a number of factors which will impact C&P's operations and which are not quantified in the proposed adjustments. Therefore, he recommends that if any CI-II adjustment is accepted, the August 1983 wage increases nevertheless should be rejected.

A major philosophical difference in calculating the impact of CI-II divides the parties. C&P states that its adjustments are based on the premise that it is proper to restate the relationships among revenues, expenses and rate base during the test year to reflect the relationships which would have existed had CI-II been in effect during the entire test year. C&P says that these restated relationships will be representative of those that will exist during the first year of new rates and are, therefore, appropriate for use in this proceeding.

On the other hand, Staff would adjust test year income and rate base only to the extent that test year figures will change as a result of CI-II. As noted, People's Counsel prefers no CI-II adjustments and would limit the wage adjustments. But, in the alternative, People's Counsel would join with Staff's position and adjust test year income and rate base only to the extent that the test year figures will change as a result of CI-II. This central

conflict between the parties is repeated in the adjustments proposed for C&P's rate base, revenues, and expenses.

B. CI-II Rate Base Adjustment.

C&P proposes to reduce rate base by $8,283,000. Of that amount, $6,237,000 relates to the estimated station equipment additions which C&P installed during the year which C&P will forego once ABI begins to supply these additions (January 1, 1983). C&P argues that the $6,237,000 should be removed from rate base since C&P will not be adding this equipment to rate base due to the implementation of CI-II. The remaining $2,046,000 relates to assets to be transferred to ABI. Both Staff and People's Counsel agree that the assets to be transferred to ABI should be deleted from rate base. People's Counsel and Staff argue that the test year rate base should not be reduced by the $6,237,000, as those station equipment additions were in fact made during the test year and are now, and will be in the future, a part of C&P's rate base.

The Commission concludes that the test year rate base should be reduced by the amount of the assets transferred by C&P to ABI on January 1, 1983. Since the assets are no longer in the rate base, it is inappropriate for the ratepayers to pay a return on those assets. This is true even though the transfer occurred outside of the test period, since the transfer is a known and certain change from the test period results which should be recognized in this proceeding.

As noted by Staff and People's Counsel, C&P's other proposed CI-II rate base adjustment differs markedly from the transfer of assets to ABI. As previously mentioned, C&P made station equipment additions during the year in the amount of $6,237,000. The Company estimates that it will not make such amount of additions during the year ending December 31, 1983 due to the fact that ABI and not C&P will be making those additions. C&P notes that had CI-II been in effect during the test year, it would not have made those additions. Accordingly, C&P believes it is

appropriate to reduce the test year rate base by the amount of those "foregone" additions.

In our opinion, the proper purpose of a CI-II adjustment is to adjust the test year operating results so as to reflect the changes in those results which have been and will be imposed by the implementation of CI-II. The fact that CI-II will result in C&P making fewer station equipment additions in the future does nothing to alter the fact that it made certain station equipment additions during the test year. This equipment remains in rate base after the implementation of CI-II, so it would be improper to remove this plant from the rate base. Accordingly, the only adjustment to rate base which we will make in response to CI-II is to remove the $2,046,000 in assets which were transferred to ABI.

C. CI-II Net Operating Income Adjustments.

Each of the three witnesses arrive at a different adjustment to revenues to account for the impact of CI-II. Mr. Sewell's Attachment R-1 (part of Company Ex. 45) shows that C&P would have foregone $12,663,000 in telephone product revenues had CI-II been in effect during the test year. The figure is composed of foregone recurring (monthly) revenues in the amount of $8,307,000, and non-recurring (installation) revenues in the amount of $4,356,000. The numbers represent revenues from certain business and residential telephone products installed by C&P during the year ending June 30, 1982, which kinds of products will be provided by ABI instead of by C&P on and after January 1, 1983.

Both Staff and People's Counsel state that C&P will not lose the test year recurring revenues, as C&P will continue to recoup most of these revenues on and after January 1, 1983. This is because ABI will not be gaining control over C&P's embedded plant on January 1, 1983, and all of the plant additions shown on Attachment R-1 are now embedded plant. Thus, these parties argue that to the extent that C&P retains the customers shown on

Attachment R-1 (and to the extent that it has inventory on hand as of December 31, 1982 to sell or lease), it will not lose the monthly recurring revenues. Accordingly, Staff and OPC do not reduce test year revenues by the $8,307,000 of recurring revenues.

While Staff accepts C&P's contention that test year non-recurring revenues should be reduced by $4,356,000, People's Counsel does not. Mr. Louiselle does not reduce test year revenues by the amounts associated with test year installations of Large and Medium Dimension products, and with Horizon systems; instead, he reduces revenues only by the installation amounts associated with test year additions in the following product lines: Comkey 416, Dataphone II, and Dataspeed. The revenues associated with the installation of these systems amount to $412,000. We believe that Mr. Henkes' adjustment is more adequately justified than Mr. Louiselle's adjustment; accordingly, we accept Mr. Henkes' number.

Various expense adjustments were also proposed by the parties. After review of these adjustments, we are persuaded to accept those proposed by Mr. Henkes where there are differences between the parties. In this regard, it is our opinion that contrary to C&P's assertions, Mr. Henkes did not double-count any expenses in his adjustments for commercial and general services. The items othewise at issue are discussed below.

Messrs. Henkes and Louiselle restrict the depreciation expense reduction to that associated with assets to be transferred to ABI. C&P shows a further reduction of $700,000, which amount is associated with station equipment connections made during the test year which C&P will not incur after December 31, 1982. Consistent with our adjustment to rate base and revenues, we accept Staff and People's Counsel's adjustment of $(133,000).

The adjustment to commercial expenses removes the test year wages and salaries of employees to be transferred to ABI. Mr. Henkes' number reflects non-management

overtime pay, an increased salary adjustment factor, and a higher intrastate allocation factor than were used by C&P. Mr. Louiselle removes labor expenses associated with the August 1983 wage increase. The adjustments are: C&P — $(10,894,000); Staff — $(11,361,086), (after our removal of the effect of the August 1983 wage increase); People's Counsel — $(10,438,000). Since Staff's calculation, as adjusted by us, appears to most accurately reflect the wages and salaries of the employees transferred to ABI, we accept Mr. Henkes' adjustment.

The adjustment to relief and pensions expense removes from test year amounts the relief and pensions expense for those employees to be transferred to ABI. Messrs. Henkes' and Louiselle's amounts reflect the wage and salary amounts which they calculated for their commercial adjustments. Mr. Henkes also uses his higher intrastate allocation factor. Staff's adjustment of $(2,716,000) is hereby accepted.

The parties also suggest that State, local and other taxes be adjusted. "Other" taxes include social security, unemployment, gross receipts, and property taxes, and reflect the wage and salary, revenues, and rate base adjustments made by each of the three witnesses. Consistent with our acceptance of Mr. Henkes' adjustments for the other items impacted by CI-II, we accept Staff's number of $(875,000), as modified by us to reflect the exclusion of the August 1983 wage increase.

The amount calculated by each party for Federal Income Taxes is a reflection of all of their other CI-II adjustments; accordingly, we accept Staff's $6,305,000 adjustment, which also reflects our adjustment.

After giving effect to the accepted adjustments for the effect of CI-II on C&P, we make the following adjustments to the test year figures: rate base — $(2,046,000); revenue — $(4,334,000); expenses — $(17,165,000); and taxes — $(5,430,000). Accordingly, we will increase net operating

income by $7,401,000 to account for the impact of CI-II. (See Appendix 4.)

As previously mentioned, C&P transferred some of its employees and other assets to ABI on January 1, 1983. MIG argues that C&P has not been adequately compensated for the non-economic assets (such as the training and work experience of transferred employees and the "goodwill" associated with the Phone Center Stores, etc.) which have been transferred from C&P to ABI. MIG was unable to quantify the value of these non-economic assets. MIG urged the Commission to act to cause the stockholders rather than ratepayers to bear the burden of the inadequate compensation for the transfer.

The record before us makes clear that it is impossible to fully identify and quantify the changes which CI-II and divestiture will have on C&P's assets and revenue requirement. Considerations such as the value to be ascribed to non-economic assets have defied quantification and have not been placed in the record in this case. In view of these unknowns, our decisions in this proceeding relating to various adjustments are cumulatively designed to prevent the ratepayers from having to bear the costs of the implementation of CI-II and AT&T's divestiture. For example, our decision rejecting C&P's proposed depreciation changes is due in part to the general concern that Maryland ratepayers should not be burdened with increased depreciation expense on plant which may not be serving those customers in the near future. Similarly, treatment of wages and salaries have been made in this case recognizing the potential unknown costs associated with CI-II and divestiture.

MIG further asserts that C&P will not be compensated for its overhead and other indirect costs which it will incur pursuant to the installation and maintenance agreement between C&P and ABI. The evidence placed before the Commission by C&P leads us to conclude that the contract

does include compensation for overhead and other indirect costs.

IV. Rate of Return

A. Introduction.

In Case No. 7591, which was decided on March 24, 1982, the Commission found an overall rate of return of 11.7 percent to be fair and reasonable to the Company at that time. This rate of return was based on the Bell System actual capital structure as of August 31, 1981, excluding the effect of Western Electric's equity, and a rate of return on common equity of 14.75 percent.

In this proceeding, the Company is seeking a rate of return of 13.06 percent based on Dr. Carleton's finding that C&P's cost of capital ranges from 12.92 percent to 13.20 percent. To arrive at this conclusion, Dr. Carleton used the Bell System consolidated capital structure as of August 31, 1982, (including both Western Electric equity, and C&P's Job Development Investment Credits — "JDIC") and cost rates as follows:

Type of Capital	*Capitalization Ratio*	*Cost Rates*	*Weighted Cost*	*Cost of Capital*
	%	%	%	
Debt	41.3	8.82	3.64	
Preferred	2.1	7.83	0.16	
Common Equity	50.5[37]	16.50-17.00	8.33-8.59	
JDIC	6.1	12.92-13.20	0.79-0.81	
Total	100.00			12.92-13.20

[37] Dr. Carleton also provided an exhibit showing his capital structure if the effect of Western Electric equity is removed. It shows the following components: Debt — 43.5 percent; Preferred — 1.9 percent; Common Equity — 48.4 percent; and JDIC — 6.2 percent. If one were to conform Dr. Carleton's capital structure with our decision in Case No. 7591 (wherein we removed JDIC and the effect of Western Electric equity from the capital structure), the following capital structure would result: Debt — 46.4 percent; Preferred — 2.0 percent; and Common Equity — 51.6 percent.

The rate of return recommendations on behalf of the Maryland Industrial Group were presented by Dr. John J. Boland. Dr. Boland bases his analysis on the actual consolidated capital structure as of August 31, 1982, adjusted for the impact of Western Electric equity as follows:

Type of Capital	*Capitalization Ratio*	*Cost Rates*	*Weighted Cost*	*Cost of Capital*
	%	%	%	
Debt	46.4	9.22	4.278	
Preferred	2.0	7.80	0.156	
Common Equity	51.6	14.76-15.89	7.616-8.199	
Total	100.00			12.050-12.633

In addition to the testimony of Dr. Boland, MIG also offered Lee Selwyn, who testified generally on the impact on rate of return of the forthcoming divestiture. It is Dr. Selwyn's recommendation that to the extent that the Commission finds that C&P's transfer of assets at book value constitutes a dividend to AT&T's shareholders, no further increase in the current return on equity of 14.75 percent should be permitted, until the magnitude and effect of such a dividend is quantified. MIG urges the Commission to incorporate Dr. Selwyn's recommendations in reaching a decision on what constitutes a fair rate of return in this case.

People's Counsel recommends an overall rate of return of not more than 11.61 percent. This overall rate of return is supported by People's Counsel Witness Richard J. Lurito. Dr. Lurito recommends the use of a hypothetical capital structure to determine C&P's cost of capital, as follows:

Type of Capital	*Capitalization Ratio*	*Cost Rates*	*Weighted Cost*	*Cost of Capital*
	%	%	%	
Debt	52.0	9.11	4.74	
Preferred Stock	3.0	7.84	0.23	
Common Equity	45.0	14.75	6.64	
Total	100.00			11.61

On brief, People's Counsel urges, in case the Commission again rejects Dr. Lurito's capital structure, to use a capital structure with no higher equity ratio than the capital structure which was adopted for rate making in the last case. People's Counsel points out that if the Commission adopts that capital structure in this proceeding, along with the Bell System's actual cost of debt and preferred and the 14.75 percent cost of equity, the overall cost of capital would just be one basis point higher than the overall rate of return recommended by Dr. Lurito based on his hypothetical capital structure.

Mr. Langsam, testifying for GSA, joins Dr. Lurito in calling for use of a hypothetical capital structure. The capital structure proposed by Mr. Langsam includes 50 percent debt and 50 percent common equity. Based upon a return on common equity recommendation of 13.5-14.5 percent for common equity, GSA recommends an overall cost of capital of 11.3 percent.

In determining the appropriate rate of return, consideration must be given to a number of financial factors, including the ability of a utility to raise capital necessary to discharge its statutory obligation to provide reliable and adequate service to the public, a level of earnings sufficient to assure confidence in the financial integrity of the company, and maintain its credit standing. These standards are stated in two landmark United States Supreme Court cases, *Bluefield Water Works and Improvement Co. v. West Virginia Public Service Commission,* 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591 (1944). Since these controlling legal principles have been discussed at length in prior Commission decisions, they need not be repeated in detail here.

B. Capital Structure.

As a first step, it is necessary to determine an appropriate capital structure for the Company. Once the ratios of the capital structure components (debt, preferred

and common stock) have been ascertained, cost rates can be applied to determine the prospective cost of capital. Since the cost of these components vary, their relative proportions in the capital structure will affect the Company's total cost of capital.

As indicated above, the rate of return recommended by the several cost of capital experts as fair and reasonable in this proceeding vary, in part, because of their differing opinions about the appropriate capital structure to be employed by the Commission. The capital ratios implicit in the recommendations of the parties, excluding Western Electric equity and JDIC, are as follows:

Capital Type	*C&P*	*MIG*	*OPC*	*G.S.A.*
	%	%	%	%
Debt	46.4	46.4	52.0	50.0
Preferred	2.0	2.0	3.0	—
Equity	51.6	51.6	45.0	50.0

In support of his actual capital structure, Dr. Carleton testified that increasing risks during the past 10 years have forced the Bell system to increase its equity ratio to 54 percent. Were the Commission to use a hypothetical capital structure during the divestiture juncture, it was the witness' opinion that the Company's future would be impaired. Also, on brief, the Company argues that the selection of a capital structure, absent an abuse of discretion, is the prerogative of corporate management. Dr. Boland, testifying for MIG, also uses C&P's actual capital structure but with JDIC and the impact of Western Electric equity removed.

Dr. Lurito agrees that it is entirely appropriate to rely upon an actual capital structure where such use produces reasonable, prudent regulatory results. However, where it can be shown that the actual Bell System capital structure is unreasonable or unsafe, the Commission has the responsibility of imputing a reasonable or desirable capital structure.

According to Dr. Lurito, an appropriate capital structure must present a balance between safety and economic considerations. First, the debt component should not reach such a level that the regulated company cannot cover interest charges during a period of depressed earnings. Therefore, corporate management must exercise particular care in developing its financing strategies so that an increase in the debt ratio does not produce a resultant increase in the cost of both debt and equity, a direction that is uneconomical and not in the interest of the stockholders or ratepayers.

In establishing an appropriate rate of return, the People's Counsel witness suggests that the Commission should consider and recognize the advantage obtained from the inclusion of a higher debt component in the capital structure. Not only is debt less costly to obtain, but the interest charges are deductible for income tax purposes and act to reduce Federal income taxes. In addition, a capital structure containing lower cost capital will produce an overall rate of return more favorable to the customers of a utility company.

In support of his proposition that a capital structure containing 45 percent equity is reasonable and safe for investors and economical for ratepayers, Dr. Lurito presented depression analyses and variability tests. These tests suggest that the before-tax coverage of a typical AT&T subsidiary would be 2.37 even if the parent company should experience a severe depression. Similarly, his variability tests indicate that the Company's after-tax coverage would be 3.23, even if a drop in earnings with only a 1 in 160 chance occurred.

The testimony of Mr. Langsam indicates that the AT&T capital structure should be adjusted for regulatory purposes. The witness asserts that the 53 percent equity ratio contained in the Company's capital structure is more than what is necessary to protect the financial integrity of the Company. In his opinion, an increase in the amount of

equity can be a management tool to provide unnecessary margins of safety or to finance a corporate purpose not necessarily associated with the actual supply of a tariffed service or equipment, by charging higher than necessary prices for regulated services. Finally, the witness testified that during the seventies, when the Bell System had a common equity ratio of 45 percent, AT&T maintained its triple A rating and was able to raise both equity and debt capital at reasonable rates. For these reasons GSA recommends that the Commission adopt a hypothetical capital which contains components of 50 percent debt and 50 percent common equity.

It has been the Commission's policy to adopt a company's actual capital structure at or near the date when the revised rates become effective, unless the actual capital structure is found to be unreasonable. The advantage of using an actual capital structure is that it represents a known structure and provides objective data for the determination of the overall cost of capital. To the extent that an actual capital structure close to the date of authorization of new rates is found to be reasonable and appropriate, it will be reflective of the actual cost of capital to the Company existing during the period the revised rates will be in effect.

However, as we indicated in previous C&P cases, we would not hesitate to adopt a hypothetical capital structure if it were proven that the actual capital structure were unreasonable.[38] Since common equity requires a higher return than do preferred stock or debt, a rate of return developed on an unnecessarily high equity ratio would generally result in a higher overall rate of return and higher rates. However, in determining what

[38] In *Re The Chesapeake and Potomac Telephone Company of Maryland*, Case No. 7591, *supra*, at 53; *Re The Chesapeake and Potomac Telephone Company of Maryland*, Case. No. 7467, Order No. 65112 (January 29, 1981), at 50; *Re The Chesapeake and Potomac Telephone Company of Maryland*, Case Nos. 7335/7305, Order No. 64111 (November 13, 1979) at 31.

overall rate is reasonable, under any particular circumstances, it also must be acknowledged that the actual capital structure has a definite effect on the cost of capital which a company incurs when it seeks additional financing. In determining the reasonableness of a particular capital structure, many factors enter into consideration. It has been argued that a slightly higher equity ratio is one factor which results in an improved bond rating, and, therefore, a lower cost of debt. A higher equity ratio also may provide financial flexibility at times when it would be uneconomic or not feasible to issue additional equity.

In C&P's recent base rate proceedings the Company and its rate of return experts recommended that the Commission adopt for the purpose of determining the overall rate of return not the actual consolidated capital structures as of the date of decision, but the Bell System's objective of achieving a capital structure with an equity ratio of 55 percent (the "objective capital structure"). Based upon the considerations of the principles of safety and economy in the capital structure and upon the evidence presented in those proceedings, the Commission rejected the objective capital structure sought by C&P. In this proceeding, the Company seeks a rate of return determination based on the actual consolidated capital structure, which now has approached AT&T's objective, containing 54 percent of equity, prior to adjustment for Western Electric's equity.

It is clear that since Case No. 7591, the corporate management of AT&T has continued to pursue a financial strategy to achieve a 55 percent objective common equity ratio for the Bell System. The issue before this Commission is whether the Company's level of equity financing contained in its capital structure is so high as to impose an unreasonable burden on ratepayers.

The Commission is in agreement with the general proposition that the selection of an appropriate capital structure is a judgment that properly rests with corporate management. However, the exercise of this judgment is

not without limits. For example, in Case No. 7591 the Commission found the actual capital structure as of the end of the test year in that recent proceeding to be reasonable, but rejected the use of the objective capital structure. The capital structure adopted in that case was comprised of 47.93 percent Debt, 2.44 percent Preferred Stock, and 49.63 percent common equity, with the effect of Western Electric equity and JDIC removed. In this proceeding, the Company is seeking to increase its equity ratio an additional 197 basis points (removing Western Electric equity and JDIC) above that found appropriate less than 11 months ago.

The Company, in this proceeding argues that increasing risks during the past 10 years have forced the Bell System to increase its equity ratio to 54 percent. As an additional reason for retaining the actual consolidated capital structure, the Company indicates a change at this critical juncture to a hypothetical capital structure would be contrary to the direction which investors expect the Company to move and would impair the Company's credit in the future.

However, it seems equally clear that the increase in the Bell System's equity ratio may also be the result of higher risks related to divestiture and the entrance by AT&T into the competitive, nonregulated sector of the economy. Additionally, the Company has not sufficiently demonstrated that the capital structure it seeks will protect the financial integrity of the corporation as well as provide the most economical rates to its customers. Furthermore, the record does not contain persuasive evidence to conclude that the adoption of a capital structure below the 53.8 percent requested by the Company would be unsafe for investors and uneconomical to ratepayers.

For the above reasons, in this proceeding we will not adopt C&P's actual capital structure to determine the Company's revenue requirement. We turn, therefore, to a hypothetical capital structure. Although the Commission

recognizes that it may be appropriate for the Company to consider more debt rather than equity as a source of future capital, we are not convinced that it would be appropriate, at this time, to impute an equity ratio below the 49.63 percent authorized in the Company's previous rate proceeding.

For the purpose of this proceeding, we will adopt all of the components of the capital structure in the same ratio as that employed by the Commission in Case No. 7591. Thus the following is the capital structure which we shall use for C&P of Maryland: Debt — 47.93 percent; Preferred Stock — 2.44 percent; and Common Equity — 49.63 percent.

We believe that this capital structure is reasonable and appropriate and, along with the associated cost rates, will yield a fair return and just and reasonable rates.

C. Cost of Common Equity Capital.

In estimating the cost of equity to C&P of Maryland, all four expert witnesses have attempted to measure the cost of equity to the parent company, AT&T.

Dr. Carleton presents four different applications of the Discounted Cash Flow ("DCF") method: (1) a standard DCF model, with earnings per share ("EPS") growth rates; (2) a standard DCF model, with dividends per share ("DPS") growth rates; (3) a standard DCF model with growth expressed as average recent retention rate times recent AT&T return on equity ("ROE"); and (4) a finite horizon DCF model. Dr. Carleton, like Messrs. Boland and Langsam, makes no allowance for financing costs or market pressure in computing his estimated cost of equity.

For use in his standard DCF model, Dr. Carleton estimates AT&T's stock price to be $58.00 to $62.00 (the final of three updated estimates). Two previous estimates proffered by Dr. Carleton during the course of these proceedings underestimated the appropriate market price,

as AT&T's market price rose significantly over the course of this proceeding. Each time the stock price rate in a DCF calculation increases, the cost of equity recommendation generally declines.

In each of the first three DCF methodologies employed by Dr. Carleton, the current AT&T dividend of $5.40 was used. The growth projections were based upon data for the period from 1970 to 1981.

Under the DCF procedures used by Dr. Carleton, the estimated adjusted dividend yield is 9.30 to 9.94 percent. He estimates growth rates of 6.80 to 8.13 percent, and a retention ratio of approximately 39 percent. Finally, Dr. Carleton tests his DCF estimates by analyzing "comparable" high-grade electrics. The bare costs of equity for his comparable utilities are in the 15.9 to 16.64 percent range.

Dr. Carleton concludes from the operation of his four DCF analyses, with his comparable earnings study as a check, that the appropriate return on common equity in this proceeding is between 16.5 percent and 17 percent.

Dr. Lurito also uses the DCF method to estimate AT&T's cost of common equity. According to this witness, the DCF method views the appropriate cost of equity as that which equals the dividend yield plus the expected growth in dividends per share.

In developing his estimated cost of equity, Dr. Lurito determined "reasonable" expected growth rates and dividend yields for AT&T, two "similar" Bell companies (Cincinnati Bell and Southern New England Telephone), and a group of 15 high grade "comparable" electrics. For these companies, Dr. Lurito analyzed historic growth rates in dividends per share, book value per share, and the growth from retained earnings. According to Dr. Lurito, the growth in dividends depends, in the long run, on the growth in earnings per share. By computing growth in book value per share, he derives the growth in earnings per share adjusted to remove any trend. In addition, Dr.

Lurito assesses the impact of current and near-term economic and financial conditions on investor growth expectations.

For purposes of his DCF analyses, Dr. Lurito uses a growth rate of 5.50 percent. This is based upon the witness' assertion that investors expect AT&T to earn 14 to 15 percent on interstate operations and 13.5 to 14 percent on intrastate operations. With a 30/70 ratio of interstate/intrastate operations applicable to C&P of Maryland, Dr. Lurito suggests that investors' return on equity expectations are approximately 14.25 to 14.75 percent. Such a rate of earnings expectation, coupled with AT&T's historical and current retention rate of 39 percent, would produce a growth rate in the 5.5 to 5.75 percent range. For purposes of analysis, Dr. Lurito uses 5.5 percent.

Use of 14.75 percent return on equity, Dr. Lurito suggests, would allow a 1.05 percent market-to-book ratio to be achieved, and would avoid a dilution of current stock. In his opinion no allowance should be given to cover future costs of pressure and potential market declines because the equity ratio is already inordinately high. According to Dr. Lurito there will be no need to sell additional common stock in the near future in order to attain a reasonable capital structure.

Finally, Dr. Lurito notes that 6 percent of AT&T's total investor-supplied capital is comprised of unamortized investment tax credits. In view of this 6 percent JDIC, Dr. Lurito states that his recommended 14.75 percent return on equity would actually enable C&P to earn about 16.3 percent on its equity investment. People's Counsel urges the Commission to consider this factor in determining the appropriate return on equity.

Dr. Boland also forecasts a cost of equity capital through the use of a DCF analysis. Dr. Boland derives his 5.5 to 6.5 percent expected growth rate from an examination of historical and current dividends and earnings per share. He uses the mid-range of AT&T stock prices during a

recent period as an "appropriate measure" of the value of AT&T stock. The mid-range price in Dr. Boland's analysis is $61 per share. Using his growth rates and dividend yields, Dr. Boland estimates the return on equity to be 14.76 to 15.89 percent.

Mr. Langsam testifies that he conducted both DCF and comparable earnings analyses to arrive at what he considers to be the appropriate return on equity. Mr. Langsam's comparable earnings study analyzes the relative risks and the associated returns for AT&T, and selected Industrials and Utilities from *Moody's* and *Standard & Poor's*. In his view, these widely recognized financial series are representative of the investment alternatives available to AT&T's current and prospective investors. The results of his study indicate to Mr. Langsam that an investment in AT&T entails the least risk out of all the alternatives studied. Again, as in the last two C&P cases, Mr. Langsam states that a 12.5 to 13.5 percent return on equity for AT&T is comparable to the current earnings of the industrials.

Using the market value ("DCF") approach, Mr. Langsam states that the cost of equity capital is the sum of the investors' dividend yield and their expectations of investment growth. Mr. Langsam points out that expectations about the Bell System's earnings and dividends must be evaluated in light of the divestiture which would cluster network access and local switching services under the jurisdiction of this Commission, while freeing all other services up to market control. With that caveat, Mr. Langsam used the market value approach to estimate AT&T's cost of equity. Incorporating a dividend yield of 8.5 to 10.0 percent and growth expectations of between 3.0 and 4.5 percent, he opined that AT&T's indicated cost of equity is in a range of 13.5 to 14.5 percent.

Mr. Langsam did not add any amount to his estimated cost of equity for market pressure or for the cost of financing. In his view, market pressure is already

reflected in AT&T's investors' dividend yields and growth expectations. With respect to financing costs, Mr. Langsam stated that his recommended cost of equity would be sufficient to prevent dilution of existing shareholders' equity when additional equity is sold. By his two (DCF and comparable earnings) studies, Mr. Langsam concludes that the appropriate return on equity capital is 13.5 to 14.5 percent.

The Commission has carefully reviewed the testimony and evidence presented by the parties regarding the cost of equity. We have considered the various criticisms of the presentation which were offered by the parties. We recognize that each of the methodologies employed by the witnesses in determining their recommended costs of equity herein requires various assumptions and judgments. We have considered the concerns of Dr. Selwyn that C&P may not be fully compensated by AT&T for C&P's role in the creation of ABI and for the transfer of assets which will occur as a result of divestiture. Also, we have given recognition to the depressed condition of the State's economy and the high unemployment rate among Maryland's labor force. In light of our evaluation of the evidence herein, we find the cost of equity to AT&T at this time to be 14.75 percent.

This is the same cost of equity which we authorized 11 months ago in Case No. 7591 and is the cost which has been recommended in this case by the witness of People's Counsel. The record before us leads us to conclude that the capital structure and cost of equity authorized 11 months ago continue to be just and reasonable and that the Company's proposed changes thereto are not justified.

Parenthetically, we note in making this determination that 6 percent of C&P's rate base is financed by Job Development Investment Tax Credits, and that the Company will be allowed to earn the overall rate of return on plant associated with those credits. We have not, however, revised the return finding downwards in recognition of this fact.

D. Cost of Debt, Preferred and Overall Rate of Return.

There is disagreement as to the appropriate cost of debt to use in this case. The witnesses for C&P and MIG recommend a cost rate for debt which is different than the cost of debt projected by Dr. Lurito for People's Counsel. Dr. Lurito puts forth a cost rate for debt which is based upon a hypothetical debt ratio significantly higher than the ratio which we have found is appropriate for rate-making purposes in this case. Dr. Lurito concedes that his proposed 9.11 percent cost of debt is inappropriate to the capital structure of the type which we have adopted. In his alternative proposal, Dr. Lurito arrived at his recommended cost rate of debt using the actual embedded long term cost rate as of December 31, 1982 of 8.74 percent and a short term debt rate estimated at 7.75 percent. The total debt rate as of December 31, 1982 of 8.63 percent is adjusted to 9.11 percent to compensate for the increased risk of the hypothetical 52 percent debt ratio utilized by Dr. Lurito.

After careful review of the testimony of evidence concerning the cost of debt, we are persuaded that the 8.82 percent actual cost rate cited by Dr. Carleton is appropriate for rate-making purposes. Accordingly, we believe that a fair rate of return is most likely to be achieved by using the following capital structure with the corresponding cost rates:

	Ratio	*Cost Rate*	*Weighted Cost*
	%	%	%
Debt	47.93	8.82	4.23
Preferred	2.44	7.84	0.19
Common Equity	49.63	14.75	7.32
Total	100.00		11.74

Combining the return on equity of 14.75 percent with the appropriate 7.84 percent cost of preferred stock and the 8.82 percent cost of debt, and using the capital structure previously found to be appropriate, results in an overall fair and reasonable rate of return of 11.74 percent.

V. REVENUE REQUIREMENT

Application of the 11.74 percent rate of return to the fair value rate base of $1,505,988,000, results in a return requirement of $176,803,000. When the adjusted test year net operating income of $161,977,000 is subtracted from this amount, the result is a net operating income deficiency of $14,826,000, which in terms of additional gross annual revenue becomes $28,200,534. Accordingly, we find that the proposed rates filed by the Company are not just and reasonable and that just and reasonable rates are those authorized herein.

VI. RATE DESIGN

A. Introduction.

In order to obtain the additional revenue requested in this case, C&P has proposed a general across-the-board increase in rates for most services, including basic local exchange service, and selective adjustments to or restructuring of a number of rates and charges. The Company proposes to restructure service connection charges, long distance rates, local operator assistance charges, and PBX trunk rates; to establish an unrecovered equipment charge; to increase the coin telephone rate and the message unit rate; and to reclassify some local exchanges.

The Company characterizes its rate proposals as an across-the-board approach which generally adheres to existing pricing principles and avoids extensive rate design restructuring. Other parties maintain that the Company has violated its own across-the-board approach by its selective proposals for lesser or greater rate increases and substantial restructuring of certain rates and charges. They emphasize that the Company has provided no cost justification for these selective rate changes.

C&P believes that its rate structure proposals are fair and equitable to its customers and are in accordance with

the previously approved rate structure allowed by this Commission. In contrast, People's Counsel believes that the Company's across-the-board increases and selective rate restructurings are unreasonable, without credible justification, and inequitably allocate the revenue requirement.

B. Cost Allocation Studies.

It is this Commission's statutory duty to determine whether C&P's proposed rates are just and reasonable. In essence, reasonable rates are those which fairly compensate the Company for the costs of providing service and which insure that all ratepayers are treated fairly and equitably by preventing undue preference and unreasonable discrimination. Substantial disparities in the rate of return among categories of service, or classes of customers, will indicate that a rate structure is unduly preferential or unreasonably prejudicial.

People's Counsel sponsors the testimony of Dr. Wilson to demonstrate that the company's current rate structure does not equitably allocate the revenue requirement among categories of service. On brief, People's Counsel argues that C&P's proposed rate changes would not remedy, and could exacerbate, the inequitable allocation. The Company sponsors the testimony of Mr. Anderson to illustrate the reasonableness and equity of its current rate structure.

Before addressing the merits of the cost-of-service studies discussed by Dr. Wilson and Mr. Anderson, it is appropriate to briefly review the procedural history of the Commission's consideration of cost allocation methodologies. In Case No. 7591, People's Counsel presented Dr. Wilson's fully distributed cost (FDC) study and C&P presented Mr. Anderson's embedded direct analysis (EDA). The Commission decided that the particulars of Dr. Wilson's cost allocation method needed to be further developed in a second phase of the proceeding. In July 1982, the Commission commenced Phase II of Case No.

7591 to seek further information to determine whether Mr. Anderson's embedded direct analysis or Dr. Wilson's fully distributed cost study would provide the most useful information about the relative costs and revenues of each category of service. During the fall of 1982, testimony was taken in Phase II.

In the meantime, C&P filed its rate application in the instant case, Case No. 7661. The embedded direct analysis and the fully distributed cost study were again before the Commission in the context of this rate filing. At the conclusion of the hearing in Case No. 7591, Phase II, the Commission directed that the issue of cost studies, as well as the pertinent parts of the record from Case Nos. 7435, 7591, Phase I and 7591, Phase II, be consolidated for briefing in this proceeding. Thus, in considering the matter of cost allocation methodologies, the Commission has considered the record in this case and the pertinent parts of the record in the aforementioned cases.

Both Mr. Anderson's and Dr. Wilson's studies are intended to demonstrate the cost and revenue effects of broad categories of telephone service. Both studies used cost and revenue data from calendar year 1980. All parties agree that such studies cannot be used to derive rates for individual service offerings. Rather, cost-of-service studies are useful to determine the revenue requirement for each of several broad service categories. A properly conceived and executed study can provide information and guidance to enable the Commission to eliminate cross-subsidization among broad service categories.

Dr. Wilson testified that deficiencies in the Company's embedded direct analysis produce significant distortions in the allocation of costs and revenues and that a fully distributed cost study provides a much more accurate assignment of costs and revenues to each of the individual service categories. In performing his fully distributed cost-of-service study, Dr. Wilson allocates common and joint costs to service categories according to cost-causative

factors such as the use of facilities, availability of facilities, and the design and performance characteristics of facilities.

Dr. Wilson believes that his study cures a major defect in the Company's embedded direct analysis. He believes that EDA's designation of a large amount of costs as "common" or "access" costs, and the assignment of these costs to the local exchange service category has produced significant allocation distortions. Further, he states that the Company's methodology has overassigned costs and underassigned revenues, to the local exchange service category. Dr. Wilson believes that the fully distributed cost study shows that local exchange rates bear a disproportionate burden in producing the Company's revenue requirement.

In contrast, the Company asserts that Dr. Wilson's fully distributed cost study is arbitrary because certain costs are inseparable and cannot be assigned to categories of services on a cost-causative basis. It is an arbitrary exercise of judgment to assign inherently inseparable and non-causally related costs to categories of service. Also, the Company, the Maryland Industrial Group and the General Services Administration aver that Dr. Wilson made substantial errors in applying his fully distributed methodology. They believe that Dr. Wilson's study arbitrarily and erroneously allocates to other service categories certain costs which should be allocated to basic service, and assigns to basic service certain revenues which should be assigned to other categories of service.

For reasons discussed below, the Commission concludes that the deficiencies in Dr. Wilson's fully distributed cost study are such that the study cannot be used as a basis for rate decisions in this case. Shortcomings in the study also prevent the Commission from adopting the study's conclusion that local exchange service contributes more than its fair share to the Company's revenue requirement.

It is clear from Dr. Wilson's testimony that a variety of cost-causative factors can be employed to fully distribute joint costs and common costs to categories of service, and that a high degree of judgment must be exercised in determining which factors shall be used. For example, Dr. Wilson presented four different fully distributed cost studies. In each study, different cost-causative factors were used to allocate various costs and revenues, and therefore each study had different results. Among the four studies, the return earned for the local exchange category ranged from 6.86 percent to 27.25 percent. The results were widely disparate because the cost-causative relationship of various service categories to the joint or common cost is often highly judgmental.

One of the most significant judgmental decisions made by Dr. Wilson relates to his apportionment of access line costs among the basic exchange, interstate toll, intrastate toll, customer premises equipment and vertical services categories. The Commission believes that Dr. Wilson's apportionment relies far too heavily upon the availability factor. More importantly, his methodology was developed prior to, and therefore does not take into consideration, the FCC's recent decision pertaining to the system of interstate access charges which will be phased-in after AT&T's divestiture in 1984. To be useful to the Commission, a fully distributed cost study must consider, in the methodology for distributing the cost for access lines, the FCC's system of access charges.

The Commission believes that Dr. Wilson erroneously assigned directory advertising revenues to the exchange service while distributing the directory costs to local exchange, interstate toll and intrastate toll categories. We note that Dr. Wilson has assigned the vast majority of station maintenance expense to the customer premises equipment category. This appears to be in contradiction to previous testimony that these expenses should be distributed in proportion to investment in exchange service and customer premises equipment. The future relevance of

Dr. Wilson's station maintenance expense allocation is further reduced by the effect of Computer II and AT&T's divestiture upon the customer premises equipment category and by the FCC's move toward deregulation of inside wiring.

Although the Commission believes that Dr. Wilson's fully distributed cost study should not be used in rate decisions in this case, the Commission does believe that there is merit to the objectives of the fully distributed cost methodology. In future cases the Commission would like to be able to more thoroughly analyze the potential for assigning various joint costs and common costs to categories of service. Contrary to the position of the Company, the Commission does not believe that the allocation of joint or common costs must always be an exercise of arbitrary discretion. Rather, in instances it may be possible to exercise reasoned judgment if more complete and accurate data were available. Were such data available, various joint or common costs may be appropriately assigned to service categories based upon cost-causative factors such as peak demand, service availability, service over distance, service over time, service connections or facility design considerations.

In the current telecommunications environment, cost-based rates will be more essential than ever before. Value-of-service pricing may have been appropriate in the past under essentially monopoly conditions. However, under the new competitive conditions brought about by Computer II and the divestiture of AT&T, cost-of-service studies will become more important in order to avoid cross-subsidization in service categories. Appropriate cost allocation methodologies must be adopted in order to assure that each service category contributes its fair share to the Company's revenue.

Therefore, the Commission believes that C&P must expand and improve its data base for performing cost-of-service studies. Data on peak usage of facilities by service

and customer class should be collected. Also, data pertaining to capacity needs for various types of service should be assembled. Finally, revenue data by tariff item should be reported. Therefore, the Commission directs the Company to collect and have available such data in the future.

The FCC's Computer II decision and the court-approved divestiture of AT&T will greatly impact upon cost of service and revenues of C&P. The deregulation and restructuring of the telecommunications industry will require the Commission to reexamine the Company's existing rate structure. It is for this reason that during December 1982, the Commission granted the motion of the Company, the Staff, and People's Counsel to expand the scope of Case No. 7450 to consider which exchange classification principles and rate structure principles may be appropriate for C&P's regulated intrastate services after divestiture of AT&T. The Commission expanded the proceedings to include consideration of the intra-LATA exchange structure, and the rate structures for access charges, basic business and residential service, service connection charges and other vertical services remaining with C&P after divestiture. Thus, many cost allocation issues will have to be considered in that proceeding.

In Case No. 7450, Phase II, the Commission expects the Company to present alternatives for allocating, to the greatest degree possible based upon cost-causation principles, joint and common costs to appropriate categories of service. Each major source of joint costs and common costs should be examined to determine whether such source can be apportioned reasonably and equitably among service categories by one, or a combination of any of the following cost-causative factors: peak demand, service availability, service over distance, service over time, service connections, and facilities design considerations. The Company should discuss why it believes that the major sources of joint costs and common costs are, or are not, reasonably and equitably allocable to categories of service. Even if the

Company doubts that a major source of joint or common costs can be assigned reasonably or equitably to specific categories of service, the Company should indicate which cost-causative factor(s) would be the most useful and reliable in allocating such joint cost or common cost among the categories of service.

In Case No. 7450, Phase II, the Commission will explore whether joint and common costs should be allocated to various service categories based upon cost-causative factors listed above rather than being assigned totally to the local exchange service category. It is expected that the Company will fully discuss cost-causative factors for assigning access line investments and central office switching equipment to specific service categories. Of course, such options must fully consider the FCC's plan to phase-in access charges for long distance calls.

Thus, in Case No. 7450, Phase II, all parties and the Commission will have an opportunity to concretely examine the usefulness of various cost allocation methodologies for establishing future rate structure principles to be employed after divestiture by AT&T. The Company, People's Counsel, the Commission's Staff and other parties should take that opportunity to improve, update and refine their proposals for cost allocation methodologies and to assure that those methodologies fully and realistically consider the effects of Computer II and AT&T's divestiture. The Commission is intent upon assuring that future rate structure principles, which will be employed after divestiture by AT&T, will be based upon the most accurate cost-of-service allocation methodology.

C. Across-the-Board Increase.

It should be emphasized at the outset that the rates which we authorize in this proceeding will likely be subject to revision after the divestiture of C&P from the Bell System. Divestiture may occur as soon as January 1, 1984. It is evident that substantial changes will occur in C&P's product and service offerings once divestiture

occurs; in fact, many of the products and services which C&P now offers will no longer be provided by C&P after divestiture. Accordingly, major restructuring of C&P's rates and charges will be necessary in the very near future. In addition, it should be noted that the Commission has initiated Case No. 7450 as a forum for consideration of major rate design proposals.

In recognition of these facts, the Commission has decided to defer most proposed rate design changes to Case No. 7450, including but not limited to the proposals of TAS and The Alarm Companies. Except for the following items, all products and services will be increased on an across-the-board basis; in addition, except for the following items, no new rates or charges shall be established, nor shall any current charges be restructured. This decision does not mean that we reject in principle the rate design proposals advocated by the parties in this proceeding; rather, the parties' proposals and those changes dictated by the break-up of the Bell System will be considered together in the generic proceeding.

D. Restoration of Service Charges.

For customers who have had their telephone service disconnected, C&P is proposing to increase the current charges from $11.50 and $13.50 to $15.00 and $18.00, for residential and business service, respectively.

Having considered the record on this matter, the Commission finds that these charges should be increased to $13.00 for residential customers and to $16.00 for business customers.

E. Bad Check Charges.

In Case No. 7591, we authorized C&P to institute the present $6.00 processing fee for dishonored checks. In consideration of the record in this proceeding, we find that an increase to $7.00 is appropriate.

F. Unrecovered Equipment Charges.

This is a new nonrecurring charge proposed by the Company. Customers will be billed for each Company-owned telephone set not returned to C&P when service is terminated. The charge varies according to the replacement cost of the eligible set minus the refurbishing cost. Mr. Ismail, a Staff witness, concluded that the Company's proposal was justified and should be permitted. The Commission has given thorough consideration to this item and concludes that the Company proposal should be accepted.

G. Coin Rates.

The Company proposes to increase the charge for a local coin telephone call from $.15 to $.25. According to the views expressed by the Company, local coin is a discretionary service, comparable to the Company's vertical services and can serve as a revenue source to help keep the rates for basic service as low as possible. Mr. Kemp testified that Company studies show that the majority use of local telephone service is by people in transit, away from their home or place of business, not by low income customers as a substitute for basic service.

The Company notes that an increase in the coin rate would be consistent with rates for local coin calls charged in other states. There are currently 30 jurisdictions in the country which have rates for local coin calls of $.20 or $.25.

The Company also points out that this Commission has not authorized an increase in the coin rate since 1977, whereas increases in rates for basic exchange and other services have been authorized.

Finally, the Company addresses the concern expressed in the Commission's final Order in Case No. 7591 with regard to the coin telephone as serving emergency use. As all outdoor telephones are now equipped with dial tone

first, no coin is required to contact the operator or 911 in an emergency or to make a non-emergency call with operator assistance. In an emergency situation a coin telephone would, therefore, be available, regardless of the charge for local coin service.

People's Counsel recommends that the price of local coin calls not be increased. This recommendation is consistent with People's Counsel's recommendation not to increase any of the services included in the local exchange category, based on the class cost-of-service study presented by Dr. Wilson which concluded that the local exchange category is currently compensatory. Also, People's Counsel suggests the initiation of a reduced coin rate at designated locations to insure that low-income individuals who might depend upon the coin telephone for basic service will not be displaced.

Staff Witness Ismail proposes implementing time measured service of coin calls, retaining the $.15 charge for the initial five minutes of a local coin call, and charging $.05 for each additional three minutes. Staff's recommendation is influenced by a concern that a substantial increase in the cost of basic service, as proposed by the Company, may cause many customers to give up basic service and rely on public coin telephone.

We share Staff's and People's Counsel's concern for the continuing affordability of basic telephone service. In this regard we conclude, however, that assuring universal telephone service is best served by keeping affordable rates for basic exchange service. We do not believe that keeping local coin rates below their fair share of rate increases at the expense of the basic exchange service would best serve the Maryland subscribers and promote the goal of continuing affordability of telephone service.

We note that, in order to continue the affordability of basic exchange service, the rate increase authorized herein is only a fraction of that originally proposed by the Company. The across-the-board increase is not of the

magnitude which was anticipated by the witnesses and which caused their concern that many customers might have to rely upon the coin phone in lieu of basic residential service.

As we stated above, in the current telecommunications environment, cost based rates will be more essential than ever before. Value of service pricing may have been appropriate in the past; however, under the new competitive conditions, it will be increasingly important to avoid any cross-subsidization of any service categories. For that reason we reject the Company's contention that local coin service, like vertical services, should serve as a revenue source to help keep the rate for basic service as low as possible.

In Case No. 7591, we rejected the Company's request for an increase in coin rates which was primarily supported by the argument that local coin telephone service could be increased because it is primarily used by people in transit. Likewise, in this case, we will not base our decision on that argument. Rather, consistent with our goal of promoting cost-based rates, we reach the decision that the local coin telephone service should bear its fair share of rate increases.

The last increase in the coin telephone rate was granted in 1977, where the Commission concluded that in order to provide the revenues necessary to recover the increased cost of coin service, the rate should be increased to $.15 a call. Since then coin rates have been maintained at $.15 while basic and other services have been increased in all succeeding rate cases.

The Company has not conducted any cost studies to support its proposal to increase the coin rate to $.25 a call. Neither does People's Counsel's cost study analyze the cost of providing coin service as a distinct and separate category. Therefore, our decision in this matter cannot be founded on any particular cost study of record. However, in view of the extent to which other basic services have

been increased over the past years while the coin rates have been held constant, it is our judgment that an increase in the coin rates is equitable and warranted at this time. We limit the increase authorized herein to a change from $.15 to $.20 a call and reject the Company's proposal for an increase to $.25.

The parties are in general agreement that if an increase in coin rates is authorized, the number of coin calls which will be made during the initial period subsequent to the increase will be reduced from the number recorded during the test year. This phenomenon is called "repression." To achieve an accurate calculation of the additional revenue which will be produced by an increase in the coin rate, repression must be quantified.

C&P determined the impact of repression from the increased rate by using an econometric model prepared by its Witness Agnich. In developing his econometric model, Mr. Agnich included the following factors as affecting demand for local coin service: The price of a local coin call, the price of other goods and services; the gross State product; and seasonality, based on data for the period 1966 to 1982. In support of Mr. Agnich's analysis, the Company presented Professor Hendrik S. Hauthakker who testified that the demand models used by Mr. Agnich are in agreement with economic theory and have been tested in accordance with the normal practices of econometrics. Professor Houthakker concluded that unless the Commission recognized the impact of repression, the Company will experience a revenue shortfall which would prevent it from earning the return authorized by the Commission.

Based on the results of Mr. Agnich's analysis, the net revenue effect of an increase of coin rates to $.20 would be an increase of $3,446,963. (In contrast, assuming no repression, there would be $6,513,536 of additional revenues).

Mr. Gallagher, on behalf of People's Counsel, and Mr. Switzer, on behalf of the Staff, presented testimony critical

of the econometric model used by Mr. Agnich. Their major criticism was based on the contention that the model used by Mr. Agnich was not suitable to quantify the impact of repression for local coin telephone service. Accordingly, both Staff and People's Counsel urge that the Company's model not be accepted as the basis for determining the net revenue effect of increasing the coin rate.

To demonstrate some of the shortcomings of the Agnich model, Mr. Gallagher showed several price elasticities and the resulting net financial effect obtained from repressions computed over various time periods. His estimates indicate that the use of time periods shorter than that utilized by Mr. Agnich would considerably reduce the financial effect on ratepayers from that suggested by the Company. For example, based on the period 1968-1982, the net financial effect is $3,446,963. Based on the period 1978-1982, the net revenue expected from increasing the coin rate to $.20 would be $5,109,218.

Mr. Gallagher further testified that, while certain price elasticity for coin service exists, other factors not taken into account in the analysis may cause coin and other revenues to increase. Simply focusing on the impact of price changes ignores the more general question of whether or not the company is likely to earn its overall rate of return during the rate effective period.

While we accept the assumption that a decrease in the number of coin calls will be experienced during the period immediately following the increase in coin rates, our consideration of all the testimony leads us to conclude that the Company's analysis overstates the repression which is likely to occur. Based on a consideration of all factors which may impact on coin call revenues and overall revenues, we will assume that a $.20 rate for coin calls will produce a net revenue increase of $5,109,200.

H. Local Operator Assistance Charges.

Consistent with the service charges proposed for operator assisted intrastate long distance calls, the Company

proposes the establishment of certain service charges to be applied to local calls for which operator assistance is required, as well as the increase of existing service charges.

The new charges which the Company proposes to institute deal with a charge for the operator's verification that a line is in working order and a charge for that same verification accompanied by an interruption of a call in the case of an emergency. Currently, such assistance is considered part of basic exchange service and there is no separate charge. The Company proposes to institute a fee of $.30 to verify that the line is busy and one of $.80 to verify and interrupt. Under the Company's proposal, there would be no charge if a line were determined to be out of order.

People's Counsel proposes a call allowance for verification. Noting that operator verification exists to determine the condition of an access line which is necessary to sustain service, People's Counsel recommends that at least one or several free operator verification calls per month be allowed per access line if a charge is adopted. Staff does not oppose the charges on the grounds that while not cost based, they will provide revenue to the Company and defer misuse of the services. Mr. Ismail recommends that if the Commission approves the charges, then the Company be ordered to notify all Maryland subscribers of the change by means of a billing insert.

We find that the verification and interruption charges proposed by the Company should be approved. No party objected to the proposal to charge for interruption of a call due to an emergency. With regard to the proposal to charge for verification that a line is in working order, we are unpersuaded that imposition of a charge for this service will impair service by deterring reports of trouble. On the record, it is undisputed that 88 percent of the requests of this nature do in fact result in a determination that a busy signal indicates that the line in question is

indeed busy. Under the Company's proposal should such a request result in a finding of trouble on the access line, no charge will be levied.

The Company further proposes that charges for operator-assisted local calls be instituted which are identical to the charges proposed for their long distance counterparts. Currently, a charge of $.30 is levied for local coin calls and message rate calls made collect or billed to a credit card or third party. No charge is made for any other local call requiring operator assistance with the exception of local conference calls. For local conference calls, there is an initial period rate for the first five minutes plus an additional period rate for each additional minute for each line in addition to the originating line.

The Company now proposes to charge $.60 for calling card calls; $1.55 for collect calls, calls billed to a third party, and station-to-station calls dialed by an operator; and $3.00 for person-to-person calls dialed by an operator. No charge would be made for calls to official public emergency agencies, calls made by customers who have difficulty dialing, or calls to official telephone company numbers. For local conference calls, the Company proposes to change the initial period from five minutes to one minute, to charge an additional period rate for each additional minute, and to charge a person-to-person operator service charge ($3.00) for each line in excess of the originating line.

In light of our refusal to adopt similar operator-assistance charges for intrastate long distance calls, it would be inconsistent to adopt them for local calls. We recognize, however, that these calls have a cost approximating the cost of making similar calls long distance. For this reason, we will keep (or institute, where applicable) a single rate for all operator-assisted local calls discussed above except conference calls; we will set the single rate of $.60. Consistent with our decision regarding long distance conference calls, we will increase the ratio for local conference service on an across-the-board basis.

I. Services Which Will Not Be Increased.

C&P proposes not increasing rates for the following services: items tariffed after August 1981; variable term payment plan options other than the month-to-month payment option, and two-tier services whose rates are vintage as required; services used by the handicapped; and Universal Emergency Number 911 Services.

Upon consideration of these items, we have decided that no increase should go into effect for variable term payment plans other than the month-to-month option; vintaged rates applicable to two-tiered services; and services used by the handicapped. With respect to items tariffed after August 1981, we limit the exemption from the across-the-board increase to rates for the sale of telephone equipment, Tariff P.S.C. Md. No. 213, approved under Transmittal No. 625, effective January 13, 1983.

In this proceeding, C&P proposes to increase the existing residential message unit rate from $.09 to $.10 and the business message unit rate from $.10 to $.11. MIG proposes that the residential message unit rate be increased to $.10 per call, but that the business rate remain at $.10.

Over the last several C&P rate cases, message unit rates have been increased at a rate well in excess of the increases for basic exchange service. In order to bring the level of these changes more in line with the rates for other services, message unit rates should not be increased in this proceeding. Accordingly, after consideration of this matter, the Commission finds that there should be no increase in message unit rates.

J. Miscellaneous.

According to Mr. Kemp, 10 local exchanges are proposed for reclassification into higher rate categories because the number weighted main stations within those exchanges have exceeded the present class limits by 5 percent or more for two consecutive review periods. In keeping with

present Commission policy, the Company's request is hereby granted.

In order to reestablish parity between business exchange access lines and business PBX trunks, the Company proposes to reduce the PBX trunk rate. Consistent with our primary decision to increase rates across-the-board without restructuring them, we will leave the PBX trunk rate undisturbed.

Consistent with the decision to generally increase charges on an across-the-board basis, we have rejected, at this time, the Company's proposal to restructure its installation and maintenance charges. Upon consideration of this matter, we have decided to permit an across-the-board increase in order processing and line connection charges.

IT IS, THEREFORE, this 18th day of February, in the year Nineteen Hundred and Eighty-three, by the Public Service Commission of Maryland,

ORDERED: (1) That the fair value of rate-making purposes of the telephone utility property of The Chesapeake and Potomac Telephone Company of Maryland, used and useful in rendering service to the public, averaged $1,505,988,000 for the 12-month period ended August 31, 1982.

(2) That the proposed rates filed in this proceeding by The Chesapeake and Potomac Telephone Company of Maryland, designed to produce $125,386,000 in additional gross annual revenues, are hereby rejected, as being unjust and unreasonable.

(3) That The Chesapeake and Potomac Telephone Company of Maryland is authorized to file with the Commission amended rate schedules which shall result in an increase of not more than $28,200,534 in gross annual revenue.

(4) That the amended rate schedules to be submitted in accordance with Paragraph 3 shall conform with the guidelines set forth in the "Rate Design" section of this Order and shall be subject to acceptance by the Commission and the designation by it of an effective date.

(5) That all motions not specifically granted by action taken herein are hereby denied.

(6) That The Chesapeake and Potomac Telephone Company of Maryland shall furnish this Commission with accurate and complete statements under oath and in convenient form, setting forth its revenues, operating expenses and other expenditures during the 12-month period ended on the last day of each month, such reports to be furnished as soon as may be reasonably practicable and convenient after the end of each calendar month during the period this Order remains effective.

FRANK O. HEINTZ,
LILO K. SCHIFTER,
WAYNE B. HAMILTON,
WILLIAM A. BADGER,
HASKELL N. ARNOLD,
Commissioners.

Appendix 1

Case No. 7661
C&P Of Maryland
Working Capital
Test Year Ending August 31, 1982
(amounts in thousands)

1. Cash Advanced	$41,657
2. Excise Tax Payable	(1,759)
3. Lag in Payment of Pro Forma Interest	(9,257)
4. Lag in Payment of Pro Forma Preferred Dividends	(145)
5. Cash Working Capital Requirement	$30,496

Appendix 2

Case No. 7661
C&P Of Maryland
Rate Base
Test Year Ended August 31, 1982
(amounts in thousands)

Plant in Service	$2,180,416
Accumulated Depreciation	(513,399)
Net Plant in Service	1,667,017
Property Held for Future Use	666
Plant Under Construction	43,112
IDC on Short-Term Plant	10,548
Materials & Supplies	16,299
Cash Working Capital	30,573
Capitalized R&SE-Net of Deferred Tax	3,546
Capitalized BIS-Net of Deferred Tax	605
Deferred Tax Amortization	2,608
Western Electric Accounts Payable	(15,930)
Accumulated Deferred Taxes	(237,418)
Customer Deposits	(5,134)
Customer Advances	(1,379)
Contractor Retentions	(356)
Pre-1971 Investment Tax Credits	(2,649)
Reserve for Uncollectibles	(995)
Expensing Station Connections	(2,610)
Computer Inquiry II	(2,046)
Separations Changes: SPF, CPE	(469)
TOTAL ADJUSTED RATE BASE	$1,505,988

Appendix 3

Case No. 7661
C&P Of Maryland
Net Operating Income
Test Year Ending August 31, 1982
(amounts in thousands)

Net Operating Income-Book	$133,077
Adjustments	
Out-of-Period State Income Tax	118
Out-of-Period Revenue Adjustment	755
Out-of-Period License Contract Credits	(27)
1980 FIT Accruals	195
Tariff Increase — March 1982	28,141
Expensing Station Connections	(10,302)
Directory Increase	2,444
Benefit Plan Changes	(1,747)
Payroll Tax Changes	(280)
Wage & Salary Increases	(15,612)
License Contract Disallowances	3,362
Advertising Expense Exclusion	98
Removal of BIS Expenditures	605
Conduit and Cost Sharing Disallowances	734
Other Tax Increases	(319)
Postage Rate Increase	(28)
Separations Changes	(639)
Expensing of Minor Purchases	(489)
Reorganization	1,380
Discontinue Hotel & Motel Commissions	39
Company Telephone Service	465
Legislative Advocacy	53
Contributions	34
IDC on Short-Term Plant	3,289
Subsidiary Formation Costs	601
Amortization — Surplus DFIT	2,913
Pro Forma Interest	5,910
Amortization Of Previously Deferred R&SE-7591	(194)
Computer Inquiry II	7,401
TOTAL	$161,977

Appendix 4

Case No. 7661
C&P Of Maryland
Summary
CI-II Adjustment
(amounts in thousands)

RATE BASE

Assets to be Transferred to ABI	$(2,046)
Total Rate Base Reduction	$(2,046)

NET OPERATING INCOME

Revenues	
Local Service Revenues	$(4,356)
Uncollectibles	(22)
Total	$(4,334)
Expenses	
Maintenance	$ (395)
Depreciation	(133)
Commercial	(11,361)
Relief & Pensions	(2,716)
GS&L	(2,023)
Operating Rents	(537)
Total	$(17,165)
Taxes	
FIT	$6,305
State, Local, and Other	(875)
Total	$5,430
Operating Income Increase	$7,401

Before The
Public Service Commission of Maryland

Case No. 7661

February 18, 1983

In The Matter of The Application of The Chesapeake and Potomac Telephone Company of Maryland For Authority to Increase and Restructure its Schedule of Rates and Charges.

William A. Badger, Commissioner, Dissenting in part and concurring in part.

While I join with my colleagues in the general findings and conclusions contained in the Opinion and Order, exception is respectfully taken to that part of the majority decision which permits an increase in the rate for local coin telephone calls.

In this proceeding, The Chesapeake and Potomac Telephone Company of Maryland (C&P) has been granted authority to increase the charge for a local coin telephone call from 15 to 20 cents. C&P's proposal to increase coin call rates was not predicated on increased costs associated in the provision of this service. Instead the Company characterizes local coin service as essentially a convenience service and, as such, believes it appropriate to utilize the additional revenues as a means to permit lower rates for other classes of monthly service.

An increase in the local coin rate was opposed by the Office of People's Counsel on the basis that cost studies undertaken by their office indicate that the current 15 cent rate is compensatory. In addition, People's Counsel recommends that reduced coin rates should be available for those customers who depend upon the coin telephone as a substitute for basic service.

I believe the decision to increase the cost of local coin telephone calls is inappropriate for several reasons. C&P, under tariffs filed with this Commission, enjoys considerable discretion in the placement of coin telephone stations throughout the state. A primary objective of the company associated with coin station installations is to provide a valuable service that will meet the needs of the community. In carrying out these responsibilities, the Company selection of locations for coin stations is guided only in part by a profit motive. In addition, social policy considerations also influence such installations, as evidenced by the presence of coin telephones along major highways to provide prompt and easy access to the telephone network in the event of emergencies.

This Commission has recognized that "value of service" and "social needs" should be considered in designing rates for telephone service to the extent permitted under the Public Service Commission Law. This "value of service" principle is clearly evident from rates authorized in this proceeding where business exchange customers will pay higher rates for basic service and message units than will residential customers. Conversely, rates for services provided to the hearing impaired will not be increased in this proceeding.

In my opinion, these rate design principles should also be extended to rates established for the use of local coin telephones. Under this concept a 25 cent rate would apply to all such coin phone installations located in such areas as airport, railroad and bus terminals, hotels, restaurants, convention centers and stadiums. The current 15 cent coin rate would be retained to recognize the nature of use associated in the coin stations located at schools, hospitals, nursing homes, senior housing and low-income housing projects as well as major highways.

The adoption of this type of rate design in this proceeding would have generated additional revenues not only to reduce monthly rates for basic exchange customers

but would also insure the continuation of low cost service to those that may rely on coin telephones for essential telephone service.

United States District Court
District of Maryland

Civil Action No. 83-855

The Chesapeake and Potomac Telephone Company of Maryland,

Plaintiff,

v.

Public Service Commission of Maryland,
Frank O. Heintz, Chairman,
William A. Badger, Commissioner,
Lilo K. Schifter, Commissioner,
Wayne B. Hamilton, Commissioner,
Haskell N. Arnold, Commissioner,

Defendants.

MOTION FOR PRELIMINARY INJUNCTION

(Filed March 23, 1983)

Plaintiff The Chesapeake and Potomac Telephone Company of Maryland, based upon the verified complaint and the attached memorandum and affidavits of David M. Gillis and Paul D. Kemp, respectfully moves this Court, pursuant to Rule 65 of the Federal Rules of Civil Procedure, to issue a preliminary injunction enjoining the Defendants from the operation, enforcement or execution of that portion of Order No. 66114 of the Maryland Public Service Commission that prevents Plaintiff from collecting intrastate charges for telephone services based on depreciation rates prescribed by the Federal Communications Commission.

Plaintiff is losing $44,000 in revenues a day and is being substantially and irreparably harmed because, under applicable regulatory law, it cannot retroactively recover this lost revenue. By contrast to the harm Plaintiff is suffering, its customers can be completely protected from any harm of paying more than just and reasonable rates by Plaintiff collecting these intrastate charges subject to refund with interest. A serious question has been raised by Plaintiff's Complaint, and in another case directly on point, a preliminary injunction was issued. Issuance of a preliminary injunction enjoining Defendants from preventing Plaintiff from collecting intrastate charges for telephone services based on FCC-prescribed depreciation rates will be in the public interest because it will stop Defendants from obstructing national telecommunications policy.

Respectfully submitted,

J. William Sarver
One East Pratt Street
Baltimore, Maryland 21202
(301) 393-7725

D. Michael Stroud
1710 H Street, N.W.
Washington, D.C. 20006
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Donald N. Rothman
Robert W. Katz
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233 East Redwood Street
Baltimore, Maryland 21202
(301) 752-4567

Attorneys for The Chesapeake and Potomac Telephone Company of Maryland

Robert A. Levetown
Mark J. Mathis
Michael J. Morrissey
Of Counsel

AFFIDAVIT OF DAVID M. GILLIS

David M. Gillis, being duly sworn, says as follows:

1. My name is David M. Gillis.

2. I am over 18 years old. I have personal knowledge of the facts contained in this affidavit. I am Comptroller of The Chesapeake and Potomac Telephone Company of Maryland ("C&P") and held this position when Order No. 66114 was issued by the Public Service Commission of Maryland on February 18, 1983. My responsibilities include maintaining C&P's books of accounts and issuing its financial reports.

3. The amount of gross annual revenue at issue in this case is $16.1 million based upon the depreciation rates prescribed by the FCC. This amounts to $44,000 in revenue a day.

DAVID M. GILLIS

Subscribed and sworn to before
me this 21st day of March, 1983

TERESA A. BOARMAN
Notary Public
Notary Public State of Maryland
My Commission Expires July 1, 1986.

In the United States District Court
For the District of Maryland

Civil Action

No. H-83-855

C&P Telephone Company

Plaintiff

v.

Public Service Commission, et al.

Defendants

TRANSCRIPT OF PROCEEDINGS

(Filed June 29, 1983)

The above-entitled case came on for trial before His Honor, Edward S. Northrop, at 10:00 a.m., April 6, 1983, at Baltimore, Maryland.

Appearances

For the Plaintiff: No. 83-1403

Michael Stroud, Esquire
Mark H. Mathis, Esquire
J. William Sarver, Esquire
Donald N. Rothman

For the Defendant:

Kirk J. Emge, Esquire
James H. DeGraffenreidt, Jr., Esquire

VOLUME II

(2) PROCEEDINGS

THE CLERK: The matter now, pending before this Court is civil docket N-83-855, Chesapeake and Potomac Telephone Company of Maryland versus Public Service Commission of Maryland, et al. For the plaintiff, Donald N. Rothman, J. William Sarver, Mark H. Mathis and D. Michael Stroud. Counsel for the defendant is Kirk M. Emge. Counsel for the proposed intervenor, James H. DeGraffenreidt, Jr. This matter now comes on for hearing on motion for plaintiff for preliminary injunction.

MR. ROTHMAN: May it please the Court, I would like to introduce to the Court a motion which was filed — I understand somewhere in the transfer of papers it may have been misplaced for admission for purposes of this case of Dennis Michael Stroud, who is a senior attorney with C&P and who is a member of the bars of the District court, I mean District of Columbia Court of Appeals, the Maryland State Bar, and Pennsylvania State Bar, and who will be carrying the argument this morning on behalf of C&P and we would like to move his admission for purposes of this case.

THE COURT: He will be admitted.

MR. ROTHMAN: Thank you, sir. Also at the table is Mark J. Mathis, a general attorney for C&P, and William

Sarver, general attorney for C&P. Mr. Sarver is admitted to the bar of this court.

(3) THE COURT: Yes, sir. Okay.

MR. ROTHMAN: Thank you.

THE COURT: All right. Whose motion is it?

MR. STROUD: Good morning, Your Honor. First of all I would like to say thank you for the opportunity to appear before the Court today. Your Honor, the issues in this case are not very complex. They are, however, very important issues and they are relatively straightforward issues, Your Honor. They involve the implementation of national telecommunications policy. I would point out to Your Honor at the outset that there was a similar case decided recently by the District Court for the Western District of Washington out in Seattle which looked at essentially the question that is presented here this morning; that is, whether or not the defendants in this case who are individual members of the Maryland Public Service Commission can ignore a duly issued order of the Federal Communications Commission instead of implementing that order and pursuing whatever remedies are available to them under law.

Now, before I get into a substantive discussion of these issues, Your Honor, if I could I would just sort of like to set the stage with a few sentences of background regarding our company and I think it woul[illegible]ake all of this really clear. The Chesapeake and Potomac Telephone Company provides both interstate and intrastate telecommunications (4) services; that is to say, Your Honor, that the telephone set that would be on your desk for example is used to originate long distance telephone calls as well as calls that are purely local in nature.

Now, as a matter and as a result of this situation the Chesapeake and Potomac Telephone Company is regulated both by the Federal Communications Commission

and also by the defendants in this case. It is this fact, Your Honor, of dual regulation which indeed presents or forms the basis for the problem that we are discussing here today and here is why I say that. The FCC has concluded pursuant to its authority granted to it by Congress under the 1934 Federal Communications Act that state depreciation practices and procedures state depreciation rates which are inconsistent with those prescribed by the Federal Communications Commission, in fact, burden intrastate telecommunications traffic and the FCC has said that these practices must be preempted and, in fact, Your Honor, on January 6th of this year it issued an order preempting the state commissions. That order was served on the defendants in this case and even though that order mandated, Your Honor, that the defendants implement the depreciation rates prescribed by the FCC, the defendants failed to do so. Thus, in C&P's last general rate case instead of calculating C&P revenue requirements using rates mandated by the FCC, the defendants in this case simply (5) ignored them and acted contrary to law.

I would ask you, Your Honor, to contrast what the defendants did here, they did not seek review of the FCC's order as its sister commission did in Virginia, for example, in the Fourth Circuit Court of Appeals. Instead, the defendants just willfully disobeyed the order. Now, a minute ago, Your Honor, I mentioned that a similar case was decided recently out in Seattle and in that case the plaintiff was the local telephone company out there the Pacific Northwest Bell Telephone Company and in that case the defendants were the Washington Transportation and Utilities Commission. Our role was similar — our role today is similar to the role played by Pacific Northwest Bell in that case and the defendants here, of course, are the same as the commission in that case.

Now, there as here, Your Honor, the defendants received the January 6th order which directed that they implement these FCC depreciation procedures. There as here the defendants refused to comply with that order.

There as here, Your Honor, the plaintiffs went into Federal District Court seeking injunctive relief under Section 401(b) of the Communications Act. And there as here the defendants attempted to avoid judicial review of their conduct by claiming that they were not persons within the meaning of Section 401(b) of the Telecommunications Act. That argument, (6) Your Honor, was rejected by the District Court in Seattle.

Nevertheless, even though it was rejected, the defendants offer that same defense to Your Honor this morning, and they set forth basically two claims as to why they are not persons within the meaning of that statute. First of all, they claim that the statute does not reach the individual members of the Public Service Commission acting in their official capacity; the second claim that they advance is that Section 401(b) was designed to reach violations of FCC orders by private individuals rather than public service commissions. Now, Your Honor, as I am sure you have looked at the papers filed by the defendants in this case, there is absolutely no citation of authority for this proposition. That same argument was advanced to the Court in Seattle, it was rejected. There is no authority whatsoever to support that position today; it should be rejected today.

Moreover, Your Honor, I would ask you to consider the logicalness of such an argument. If this Court were to adopt the construction of the statute urged by the defendants in this case, that would mean that the state commissions would be free to sort of pick and choose which of the FCC's orders they would elect to implement; and when challenged on the ones that they refused to implement, would simply attempt to shield themselves by claiming that they were not persons within the meaning of Section 401(b). Such an order — what (7) this would mean, Your Honor, that many orders of the FCC would not and indeed could not be enforced. The Court in Seattle rejected this argument. It concluded that Congress could not have intended such an anomalous result. Instead, that

court concluded that what Congress intended — that the defendants in this case, like all other defendants, prosecute any grievances that they might have against the FCC orders in the U.S. Courts of Appeal. As a result of that construction of the Statute, the Seattle court rejected this claim.

We would ask Your Honor to reject it here this morning as well. Section 401(b), Your Honor, sets forth several preconditions to the issuance of an injunction. With the exception of the meaning of the word person which the defendants dispute, there is virtually no dispute that every other precondition of the statute has been met. Nevertheless, the defendants assert basically two reasons as to why an injunction should not issue. First of all, they suggest that the issuance of an injunction in this case might violate the principles of comity as embodied in the Johnson Act. The other argument they make is that the company indeed has not satisfied the Fourth Circuit's requirements for the issuance of injunctive relief and I would like to discuss both of these points, Your Honor, just very briefly.

The Johnson Act is set forth in 28 USC 1342, and it is quite specific. In order for the Johnson Act to bar (8) the granting of injunctive relief, each and every condition of that Act, Your Honor, has to be met and those conditions are stated in the Act in the conjunctive. In point of fact, under the facts of this case those conditions have not been met; the very first condition of the Johnson Act indeed has not been met. Under the Johnson Act the requirement is that jurisdiction in the District Court must be based solely upon either diversity of citizenship or repugnance of the order issued by the defendants to the federal constitution. However, if the Court reviews our papers, it is clear that we are filing this action today under 47 USC Section 401(b) which is a federal statute. If the Court reviews our underlying complaint, you will also see a count which sounds under Section 220(b) of the Federal Communications Act. We are not here on the basis of diversity of

citizenship; we are not here as a result solely of the repugnance of the Commission's order to the constitution. Accordingly, Your Honor, that should end any discussion of the Johnson Act but, if the Court wanted to look further, there is also the problem that the violation which we are addressing today affects intrastate commerce, again taking our action outside the scope of the Johnson Act.

Now, the cases cited by the defendants regarding these matters either did not result in the Johnson Act barring the injunctive relief or are distinguishable under (9) our facts. So, a final point I might add, Your Honor, the court in Seattle carefully considered the Johnson Act arguments, it was advanced by the defendants out there as it is here today, and it was rejected.

Defendants also argue that general principles of comity should exercise the Court here today. However, the principles of comity does not likewise apply. The reason they do not apply the doctrine that is designed to preclude the district courts from causing needless friction with the states in the administration of state affairs, their own state affairs. Thus, if we were discussing here at what rate for example should be charged for unlisted telephone numbers which is what the discussion was in one of the cases cited by the defendants here, the Tucker case, then perhaps that would be a situation, Your Honor, in which comity or principles of comity would apply. But where in the instant case the state commission has blatantly disobeyed a duly issued order of the Federal Communications Commission, an order which affects interstate commerce then the District Court must not retire, Your Honor. Instead, the District Court must declare the law and enforce the law and the Younger case cited by the defendants does not alter that conclusion. Indeed the Younger case expressly recommends that federal courts may enjoin in state actions when expressly authorized by Congress. Congress has so authorized in Section 401(b).

(10) Another argument advanced by the defendants is that the Court decline to exercise jurisdiction because this case is still pending before the Maryland Public Service Commission on a petition for reconsideration. The fact of the matter is, Your Honor, that the company did petition for reconsideration on some points but it expressly did not petition for reconsideration regarding the depreciation issues. We did ask that the commission give us the opportunity to collect the revenues which are in dispute here today while we pursued our remedies in Federal Court and, indeed, if that request had been granted we probably wouldn't be here today. But I would like for the Court to bear in mind as you consider this, consider whether or not we still have a remedy pending before the Public Service Commission. There is no rule that requires the Maryland Public Service Commission to act within any specified time limit on questions of reconsideration. In fact, the C&P petitioned for reconsideration in case number 7467 over two years ago and to this day we have not received a response from the defendants.

Now, having established, Your Honor, that the Johnson Act does not apply for the comity principles embodied in it, the only question remaining in it is whether or not the C&P has met the Fourth Circuit's requirements for injunctive relief. Here when I talk about the requirements I (11) am referring to the requirements enunciated in the Blackwelder case cited by all the parties here. As you know, Your Honor, the Fourth Circuit follows the balance of hardship test and under that test the threshold question is whether or not the risk of harm to the plaintiff C&P if the injunction is not issued outweighs any risk of harm to the defendants if the injunction is granted and the underlying issue ultimately decided in the defendant's favor. In its papers C&P has established that it is losing revenues in the amount of $44,000 a day — $44,000 a day, Your Honor! And that this harm is irreparable because the Maryland Commission lacks the authority to order retroactive rates. There is no way that we can recoup this.

The defendants have put forth two arguments which are designed to show that the harm C&P is suffering is not irreparable. Now, even though the defendants concede that the Maryland Public Service Commission lacks the authority to order retroactive rates, it nevertheless argues that this Court has the authority to order retroactive rates. They never explain how you get around the Maryland precedent that says you cannot. They never explain why it is improbable for the Commission to order retroactive rates but it would be proper for the Court to do so.

THE COURT: Your contention is that the Commission can fix the rate, isn't that your position?

(12) MR. STROUD: My position is that the Commission could fix the rate on a forward looking basis.

THE COURT: What about this one, 2.2 percent, but they have the power to fix it, don't they?

MR. STROUD: They have the power to fix the 2.2 percent rate from this date forward but they don't the right to fix the rate from today back two years. That is our contention.

THE COURT: Who does that?

MR. STROUD: That is your irreparable harm.

THE COURT: If they have the power to fix the rate they can fix it from this day forward and you would be satisfied, wouldn't you?

MR. STROUD: Well, we would be satisfied only as this date forward, Your Honor—

THE COURT: Who does the other? That is the Fourth Circuit who does that then, isn't it?

MR. STROUD: No, Your Honor. What I am saying is from January 6th — really from the date of the

defendants' order in this case, February 18th, forward up until the time that this Court decides, we have lost each day $44,000 which cannot be made up. This Commission cannot make it up, indeed as I will demonstrate in my argument that even the Court can't make it up. That is our irreparable harm and the reason we are here today to preclude that harm from (13) continuing into the future.

THE COURT: Your contention is that nobody can do anything for you?

MR. STROUD: That's right, not for the time that already expired.

THE COURT: Okay.

MR. STROUD: That is the irreparable harm in this case.

THE COURT: All right.

MR. STROUD: Now, with respect to whether or not this Commission could order the — rather this Court could order the State Commission to make us whole, and that is the discussion we just had, the fact of the matter is that the Court cannot order the Commission to do anything which it has not been empowered to do by the Maryland legislature and this Commission has held that it has no legislative authority whatsoever to engage in retroactive rate making, it has no authority to set future rates to recover past losses.

Finally, Your Honor, the District Court itself cannot engage in the rate making function because that function is generally conceded to be a legislative rather than a judicial function.

The second argument advanced by the defendants is that depreciation is a so-called non-cash expense and, therefore, C&P is not really being harmed. But this (14) argument, Your Honor, ignores reality, it ignores the reality of the world in which C&P operates and it

certainly ignores the entire purpose for depreciation. Depreciation, as the Court understands, is a power by which C&P recovers its investment in plant and property used to provide telecommunications service. Now, when that property — or if when that property is consumed, Your Honor, either through obsolescence or our inability to repair it and put it can back into servucem if C&P has not recovered its investment in that equipment at the time that that event occurs then C&P simply has to go out to borrow money to refinance the plant. So it is because C&P does not have the $44,000 each day that it requires that we are being irreparably harmed. C&P has to go out and borrow hard cash because of the fact at that time defendants are precluding us from recovering our capital investment in an orderly fashion. So it is a non-cash issue, Your Honor. We simply don't have the cash.

The second element of the balance of hardship test is also met, Your Honor, and I say that for this matter in contrast to the harm which C&P is suffering, the $44,000 a day, only a 2.2 percent rate increase would be required to cover the depreciation expenses which are at issue here. This would mean, Your Honor, an increase in basic service rates across this state of only a penny a day or less. We (15) would submit that such an increase would not burden the ratepayers of this state.

In addition, there is absolutely no risk of harm to the ratepayers of this state because C&P has volunteered to collect these additional revenues and to return them to the ratepayers if we are unsuccessful on the underlying complaint, with interest. Now, the claim that any increase in telephone rates would cause subscribers to give up their telephone service indeed really rings hollow, Your Honor, when the facts show that in Baltimore City, for example, if the rate increase we are requesting here were granted it would only increase telephone rates by a penny a day. Thus when the facts are weighed, Your Honor, the scales tip in favor of the plaintiffs and in favor of issuance of this injunction.

Under the Blackwelder case, the only other question remaining before this Court is whether or not our complaint presents a serious question. C&P submits and the Court in Seattle held, that the failure of a state agency to follow a duly promulgated order by the Federal Communications Commission indeed constitutes a serious question. Therefore, under the law of this jurisdiction, Your Honor, the company is entitled to the injunction.

The defendants cite the Airport Commission of Forsythe County (phonetic) as authority for their argument (16) that this Court has to look at the likelihood of success on the merits, but in the Blackwelder case the Court pointed out that the Forsythe standard only applies for cases on the appellate level. It does not apply in the District Court. Therefore, the question of likelihood of success on the merits is not a proper matter to be considered by the District Court. Even if the Court wanted to look at it we are virtually one hundred percent sure we would prevail in this case because there is no question that the defendants in this case violated the FCC's order. Furthermore, Your Honor, the defendants concede that the question of the legality of the FCC's order. The issue on the merits is not before this Court, that is a matter for the Fourth Circuit Court of Appeals.

I want to address one final point, Your Honor, and then I will sit down, and that is the public interest. First I would like for the Court to consider as it decides this case the public interest as expressed by the Federal Communications Commission; that is the interest in developing competitive dynamic telecommunications.

The other interest I would like for the Court to consider is our interest in a federal system of government. Now, under that system inconsistent state action or inconsistent decisions by the state must give way to the federal decision unless that federal decision is overturned (17) through lawful processes as the Court stated in Blackwelder, and I just want to paraphrase this, the presence of

a federal statute prohibiting the alleged acts of the defendants and supplying the gravamen of the complaint aligns C&P in setting our company's rate in the stead of the public's interest. This is so especially where, as here, the statute expressly authorizes interlocutory injunctive relief.

So, in conclusion, Your Honor, I would strenuously urge that this case is on all fours with the decision that was rendered in Seattle; the issues are identical, the rulings would be too. The defendants have elected to ignore lawful procedures and have elected to ignore a duly promulgated order of the FCC. Now, Your Honor, I would like to contrast what the defendants have done in this case with what the Virginia State corporation has done only yesterday. In deference to the preemption order which they received shortly after January 6th, it has permitted C&P of Virginia to implement depreciation proceeds which the state commission opposed previously on the basis that they have to follow the law and the preemption order is the law until it is reversed.

THE COURT: Who fixed it?

MR. STROUD: Who fixed the law, Your Honor?

THE COURT: No, no. Who fixed the rate or whatever it was, the depreciation.

THE WITNESS: The Virginia State Corporation (18) Commission.

THE COURT: They did?

MR STROUD: Yes, Your Honor, the depreciation rate, however, was set by the FCC.

THE COURT: But then the Commission fixed the rate?

MR. STROUD: That's right, Your Honor.

THE COURT: Okay.

MR. STROUD: Now, the C&P had requested the Commission be enjoined from preventing C&P from collecting an additional 2.2 percent across the board increase. Now, there is a difference between our case and the case in Seattle, the Maryland Commission has already stated because of the pending divestiture of the Bell companies from the AT&T and the need to restructure C&P's rates following that event, the appropriate rate to generate the rates required to increase the rate is broad. Now, the Commission should not complain that it wants a different rate merely because it is required to follow the FCC's preemption order. Now, moreover, returning this case to the defendants as was done in Seattle may render this entire procedure a gesture in considering the FCC described depreciation rates if they elect to reduce some other cost such as rate of return for example, thus resulting in no increase in revenues to the companies. Other costs will not decrease because the depreciation decreases are— (19) remembering we are going to have to pay the same wages and the same interest rates.

THE COURT: I don't understand what you are saying, now.

MR. STROUD: What they have suggested, Your Honor, is that the Court send this case back to them.

THE COURT: Yes.

MR. STROUD: So they could fashion rates rather than just go across the board, that they may consider what impact, if any, the allowance of this expense will have on C&P's overall financial picture.

THE COURT: Yes.

MR. STROUD: And if they, for example, may say well, we think that we are bound by the Federal Court's decision to put these depreciation rates in place, but we think as a result of doing that we ought to reduce some other costs so that the net result is no change in your our revenues, then we haven't advanced our cause at all.

THE COURT: What do you want me to do about that?

MR. STROUD: What I would like for you to do is simply direct the defendants to implement the 2.2 percent rate increase today consistent with the decision that they made on February 18th, referring this across the board increase.

If there are no further questions, Your Honor—

(20) THE COURT: Not right now.

MR. STROUD: Thank you.

MR. EMGE: Your Honor, if it please the Court, my name is Kirk Emge and I am an attorney with the Public Service Commission and I am here representing the Public Service Commission and the named defendants. There are very, very serious questions raised by the complaint and the request for preliminary injunction as filed by the plaintiff but I will try to be as brief as possible in responding to their motion and the arguments that they have made today.

For reasons that are set forth in our memorandum and for which I will briefly pass upon today, the defendants contend that this Court does not have jurisdiction to entertain the complaint that they have filed — the plaintiffs have filed, nor to issue the preliminary injunction that they seek. Assuming that the Court technically has jurisdiction over this matter, what is before Your Honor today is a classic example of a case where considerations of federal and state comity, which are the corner stone of our federal system, require a federal court to decline to intervene in a vital state matter and issue an injunction, particularly when the plaintiffs have available to them, but have not elected at this point to pursue, adequate remedies in state court. It was actions such as the action that was filed by C&P that prompted Congress to enact (21) the Johnson Act to prevent utilities from forum shopping in matters involving utility rates when they had an adequate and speedy remedy in the state courts. Clearly C&P is forum shopping in this

case, they obviously have a right under Maryland law to go into the state courts and seek judicial review, that remedy is a speedy remedy. The same powers that this Court has an equity court in Maryland has and if they are irreparably injured, which we claim they are not, they can certainly seek appropriate relief from a state court rather than this Court in involving itself in matters that are purely local state matters.

What C&P has done is selected this forum to ask this Court to make one decision in a case that involves 30 or 35 interrelated issues of which this is one. What they are seeking this Court to do is to establish rates in Maryland, they are seeking from this Court a $16 million rate increase. Now, they have not presented to you any evidence that a $16 million rates increase is required for them to have just and reasonable rates, or to result in rates that don't confiscate their property. There is no evidence at all with respect to that. What is before Your Honor is a simple mathematical calculation of a revenue requirement in affect, associated with but one issue and as we have stated rate cases involve consideration of many, many interrelated issues and they involve the exercise of expert judgment. And, with respect (22) to rates for telephone service, Congress in the Communication Act has wisely left the states to have exclusive authority over establishing intrastate telephone rates.

THE COURT: You don't recognize they got dual authority here in this particular instance. You see, in the local ratemaking body—

MR. EMGE: Your Honor, there is dual authority and it is clearly set forth in the Communications Act the Federal Communications Commission has sole authority over interstate telephone rates. Congress has given the state themselves and through the states themselves the state commissions sole authority over interstate. We certainly recognize the dual authority alluded to by the plaintiffs. Now, I will get to our specification with respect to the

various questions relating to jurisdiction and the need for preliminary injunction.

I think it is important at this point to realize that what is before this Court today, despite the many arguments of the plaintiffs, is only the issue as to whether the Court should exercise its discretion and issue a temporary injunction. We are not here to try the merits, we are not here to convince you that the FCC can or cannot preempt the Maryland Commission's ratemaking authority over intrastate services. As outlined in our memo and as (23) indicated by the District Court in Seattle, the only basis for jurisdiction of this Court is found, if it exists at all, in Section 401(b) of the Communications Act. And that depends upon whether one considers the Public Service Commission or a state agency like the Public Service Commission to be a person within the definition of that Act. Now, the Court in Seattle concluded that our sister commission was a person, but it also indicated that this was a case of first impression; this is the first time that this particular provision of the Communications Act has been construed by a Federal District Court in this type of matter. That is why there are no case citations in our memorandum and that is why there is no support case citation-wise for the District Court's decision in Washington that indicates the Commission should be considered a person for purposes of enforcement of the Act.

Now, there are very good reasons why the Commission should not be considered to be a person. As the Supreme Court noted in the Palmer case, when the problem of construction inflicts one of the recurrent statutes, striking a balance between national and state authority. In one of the most extensive areas of government, the statute should be construed to avoid inroads by implication into state authority. That is what they are suggesting that you do. If you read the definition of person, there is no entity in that (24) definition that remotely resembles a governmental agency. They are private entities that are defined in the Communications Act as persons. And the

reason for that is clear, Congress did not want the FCC regulating state commissions, they are only to regulate carriers, intrastate telephone service carriers.

In addition, unlike private parties, state governmental decisions are reviewable in the courts. The plaintiff claims that there is no mechanism for enforcing the FCC's decision if the Commission is wrong. That is completely untrue. The state courts have full authority under the Public Service Commission law to determine if our decision is contrary to federal law and if so, they will enforce that federal law. That is the mechanism for enforcement, review, judicial review in the state courts ultimately reviewable by the U.S. Supreme Court if the state courts are incorrect in their assessment of the federal law.

In addition, what we have as far as enforcement is concerned is not enforcement of an order against an individual private entity who is arguably acting to get private gain. What you have is an attempt to enforce an FCC order against a state agency that is arguably, and we believe correctly acting in the public interest as that agency perceives the public interest, so, there is a clear distinction. None of this discussion was included in the (25) District Court judges decision in the Pacific Bell case. He concluded that there was no means of enforcement. We maintain that there clearly is a mechanism for enforcement in the state courts, that the plaintiffs have not chosen at this point to pursue, he concluded that there was no rational reason for excluding commissions. I think there are very good reasons for excluding commissions from the definition of person, including the fact that our decisions are reviewable in state courts, the fact that we are a state agency, therefore, we are not private individuals and we are acting in the public interest, and because Congress has specifically given us the authority over intrastate services.

Now, to get to the Johnson Act, which is the other jurisdictional basis. If the Johnson Act applies, this Court

has no authority to issue an injunction. As the plaintiff indicated in its argument, there are four preconditions to the Johnson Act; first of all, it should be noted that no, there is no dispute that this is a rate order involved here, so the Johnson Act applies. The first condition is as the plaintiff indicated the cause of action not be based solely on citizenship or repugnance to the federal constitution. As the Federal Court appropriately noted in Seattle, if jurisdiction is not found under 401(b) it does not exist. Therefore, as we maintain 401(b) does not include the Commission as a person, therefore the plaintiffs have to fall (26) back on the argument that our decision is repugnant to the constitution and the first element of the Johnson Act is satisfied. First element is the effect, does the commission's order affect interstate commerce. The cases we stated in our preliminary brief I believe address that point adequately and I won't reiterate them here.

The Court held intrastate communications does not affect interstate commerce for purposes of the Johnson Act. The final two conditions I don't believe that the plaintiffs have disputed, one is that notice of hearing were held and there can be no dispute; and the other one an adequate and speedy, and I think if one reads the Public Service Commission law there is remedy under state law, and, it certainly is speedy because of Article 78 decision of the Commission, civil matters except for election causes and except for my knowledge there are no election causes pending in the circuit court in the state.

Now, we believe we have established that there is a lack of jurisdiction over this subject matter and, therefore, the injunction should not be issued, the preliminary injunction should not be issued. In the event you find that technically there is some jurisdiction over this matter, we maintain that there has been no showing by the plaintiff that the Court should exercise a sound discretion and issue a temporary injunction. First I think (27) there is basic agreement on what the four standards are in this circuit as far as issuing preliminary injunctions.

The first issue and I think a principal issue to be addressed is has C&P demonstrated that it will suffer irreparable injury if an injunction is not issued. First let me state that we vigorously dispute their contention that they are losing $44,000 a day. That $44,000 a day is based upon a mathematical computation of some abstract revenue effect associated with but one issue in a rate case. There has been no showing that if this Court directed that the Commission follow the FCC's preemption order, as the Court did in Washington, that that would be the result.

With respect to whether they are irreparably harmed, I think the defendants — the plaintiffs have failed to establish that they — that this Court or a state court could not fashion appropriate remedy in the unlikely event that they should prevail on the merits of this case. All of the cases that they allude to, the precedent in Maryland that is unnamed but alluded to in their argument, relate to a commission's authority to establish retroactive rates; the cases that we have cited in our memorandum deal with a Court's ability to fashion appropriate relief. What the plaintiffs are arguing or seem to argue or which they have not addressed adequately is that if a court does not have this authority. What value is their right to appeal if a (28) decision is made down the road and the Court can't come back and fashion appropriate remedy that would make them whole? What value do they have to take an appeal? And I think the cases that we have cited in our memorandum on this point discuss that very point.

In addition, I think the Court should consider the nature of depreciation expense. Depreciation expense is recovery of capital, it is not an actual cash expenditure that is now being paid out by the company. They are not paying out, they are not losing $44,000 a day. They indicate well, we are not getting the money and we have to replace this equipment at the present time so, therefore, we have to go out and borrow the money. What they don't tell you is if they have to go out and borrow the money and replace it then it is not recovered through depreciation expense.

That money they have to borrow is included in their rates and they are getting a return on it. In other words, if they have to for some reason need an unquantifiable amount of money that they have to go out and borrow because we didn't increase the rates, if they in fact have to go out and borrow that money they will be receiving compensation for that in their rates and that will be reflected and they will, therefore, not suffer any harm.

We think there has been a complete lack of any showing by the plaintiff, only conclusionary statements that (29) they will be irreparably harmed if the Court does issue the preliminary injunction. That is simply not true. There has been no showing that they have suffered and will suffer any harm if this Court fails to exercise its discretion. However, there will be clearly harm, substantial harm for some individuals, if this injunction is not issued. Maybe 2.2 percent does not sound like a large increase but for some people, on the bottom line there may be someone out there where service will be terminated because they can't pay that additional amount of money. I don't know that the plaintiff can say there isn't anyone out there, there probably is one out there are who will suffer irreparably if this injunction is issued. More importantly, and I think the Court if it reads our memo will see this, as well as when the Courts reads our memo it will see this point as well, the fact is that the customers who will be paying this increased rate now, if the Court issues an injunction, will not be the same customers who receive the refund somewhere down the road if the plaintiff is found to be wrong. What will happen is that there is constant customer turnover and new customers replacing old customers and new customers who are in existence when the Commission's decision is rendered. The customers who receive the refund, who didn't pay for the higher rates, will receive a windfall. So, there is harm. It is something that can't be brushed aside. The identity of (30) customers is a valid issue which would result in irreparable injuries to certain parties if this injunction is granted.

Now, with respect to the fourth test, which is the likelihood — the third test, the likelihood of success. The standard as outlined in Blackwelder and indicated by the plaintiff involves first a balancing of hardship. We maintain that when you balance the hardships it is clearly on the side of the ratepayers since the company is not going to be harmed in any way by not issuing the injunction. So, therefore, you do get to the likelihood of success on the merits. We are not trying the merits at this point but it should be noted that what the plaintiffs are seeking this Court to issue, what they want in the way of relief, is a declaratory injunction that the Commission's action violates federal law and, therefore, we are pre-empted. That issue is presently before the Fourth Circuit and will be decided by the Fourth Circuit on appeal by the Corporation's Commission of Virginia and others.

Now, this gives me an appropriate time to point out why our failure to take an appeal is irrelevant to the issues that are before the Court; the plaintiffs make a great deal out of this indicating that what we should have done was file the appeal and pursued the remedy there rather than what we did. What we did was, because we have an obligation under state law to set rates for intrastate telephone service and (31) that involves determining what we can and what we cannot do, that that is why we did what we did. Why we didn't file an appeal from the FCC's decision or why we didn't petition to intervene is also readily apparent. We knew Virginia was going to file the appeal, we have limited resources, we can't file appeals in every federal case that may involve our interest and we don't generally if we know that our interests are going to be adequately represented. But more importantly, we are a member of the National Association of Regulatory Commissioners, they are representing us. We filed a petition to intervene in the Fourth Circuit decision, so in effect we are a party in that proceeding through our participation in the national organization. So that two of the issues relating to that case simply is not relevant to what is before this Court.

With respect to the public interest, I think, several things should be said. One is that what they seek is an injunction that doesn't maintain the status quo but changes the status quo. The second is that the issuance of an injunction will directly involve — in the nature that the plaintiffs seek will directly involve this Court in ratemaking. They want you to set state rates. In their argument about irreparable injury they claim that you can't set retroactive rates because you could be engaging in ratemaking and that is a legislative function. But in effect (32) what they are asking you to do is issue an injunction that has the same affect to allow them to raise whatever rates they want. They are the ones that are the actors, they are the ones establishing the rate, but it will be Your Honor's order that permits them to do that.

THE COURT: Why won't you do it.

MR. EMGE: Your Honor, we have concluded that the federal law does not preempt us and, therefore, we are protecting the Maryland ratepayers' interest.

THE COURT: But won't you do it?

MR. EMGE: Oh, no, whatever Your Honor says, we certainly would obey Your Honor's order.

THE COURT: You are much more capable of doing it than I am, aren't you?

MR. EMGE: Your Honor, as we have noted in our memorandum, if the Court is inclined to conclude that it has jurisdiction and that a preliminary injunction should be issued, we would recommend strongly that the injunction merely instruct the defendants to obey the FCC's order in the pending petition for rehearing, and that is exactly what the Court in Washington did. We would strongly suggest that any order that permits C&P to establish intrastate rates without the approval of the Commission would be contrary to the public interest and would be inconsistent with the decision in the Washington Court. Now, the company has maintained (33) that their

petition for rehearing technically does not include or request that the Commission reconsider its decision on depreciation rates. Well, even if that were true, and we are not going to dispute it here, the Commission has full authority under Article 78 to rehear any matter on its own motion. And so, if Your Honor were inclined to issue such an injunction, the Commission certainly would have authority under state law to reconsider its decision with respect to that issue, and render an appropriate decision in accordance with Your Honor's instructions. And we would strongly recommend that course of action if Your Honor—

THE COURT: That's what the Washington Court did?

MR. EMGE: Oh, yes, Your Honor. You will notice when you read the order that the judge was very careful not to conclude that they were losing a hundred thousand dollars a month as the plaintiffs contended, he cross that language out. He also carefully included language that the defendants were entitled to spread the increase, whatever that amount would be, in any way they chose to be appropriate under state law, and did not limit it to an across-the-board increase.

THE COURT: All right.

MR. EMGE: Your Honor, we maintain that there is no jurisdiction over this matter under the relevant section of the Communications Act. However, as I have stated before, if Your Honor concludes that the plaintiff has shown that he (34) they will be irreparably harmed and that argument was not made in the Washington case. You will notice there is no discussion, there is just a discussion there was an irreparable injury, no discussion why. If Your Honor concludes there will be irreparable harm and outweighs the harm that will be imposed upon the ratepayers of the company and concludes that this is an appropriate case for the federal courts to intervene even though there is an adequate state remedy that the plaintiffs have not pursued, we would recommend that Your Honor merely issue an order which conforms in

general to the order that was issued by the District Court in the State of Washington and only instruct the defendants to — the binding nature of the FCC's preemption order. Thank you, Your Honor.

MR. DeGRAFFENREIDT: Your Honor, may it please the Court, I'm James DeGraffenreidt, representing the Office of the People's Counsel. I have pending before you a motion for leave to intervenue in his this matter as a matter of right under Rule 24(a).

THE COURT: Have you got an order?

MR. DeGRAFFENREIDT: I have not received an order.

THE COURT: Well, why didn't you draw an order? Has he got an order attached to it? Look through this for me.

(A pause in the proceedings.)

(35) THE COURT: No reason why you shouldn't intervene and you have to have an order attached here.

MR. DeGRAFFENREIDT: Your Honor, I hadn't been informed that it had been granted.

THE COURT: Because I just granted it.

MR. ROTHMAN: Your Honor I wanted to say on that—

THE COURT: You don't want me to intervene.

MR. ROTHMAN: We do not oppose it although we do not think it is a matter of rights since the interests of peoples' counsel—

THE COURT: We can argue about that.

MR. ROTHMAN: I just wanted the record to show that we believe their interest to be the same as the Public Service Commission and that they are adequately represented in this proceeding, but we do not oppose.

THE COURT: Well, we will let him say something, won't we?

MR. ROTHMAN: Yes, sir.

MR. DeGRAFFENREIDT: Your Honor, I will keep my comments brief because I feel that—

THE COURT: Sure, you have gotten plenty filed here.

MR. DeGRAFFENREIDT: I indeed filed a memorandum in opposition to the preliminary injunction requests, and I would simply like to reiterate that the issue before the (36) Court today is whether or not the C&P is entitled to a preliminary injunction, and I would like to re-emphasize, as I have done in my memoranda, that they have not met the criteria which are applicable for the granting of such a preliminary injunction.

The only point that I would like to emphasize is that the company has made the argument that they are suffering irreparable injury and that there will have been no harm to ratepayers in the balancing test that is set forth in Blackwelder. I agree, as you can see in my memorandum, with Mr. Emge that the company does not suffer irreparable harm because we are talking about a non-cash expense item which in the event that the — that their depreciation rates in effect do not permit the company to recover its capital, they recover it in rates from ratepayers and to the extent that they incur any kind of borrowing costs. So I would submit that they are not suffering any irreparable harm and indeed their affidavits don't even allege that they suffer harm. It is merely a blanket statement that $16.1 million is the amount in controversy and they leave it at that.

I would also point out that on the other hand, whereas the phone company is talking about a non-cash expense item if their preliminary injunction request is granted, real dollars are going to come out of the pockets of Maryland ratepayers to accommodate the basic effect of

the revenue (37) increase that would — that they allege is associated with the failure of the Public Service Commission to go along with the FCC's order. So I simply emphasize to you, in addition to the arguments that are already set forth in my memoranda, that the company does not suffer any irreparable harm and that there is a real harm in a sense that ratepayers would be paying real money if the intervening period pending final resolution of this matter. Thank you, Your Honor.

THE COURT: All right.

MR. STROUD: Your Honor, if I might have just a minute of rebuttal.

THE COURT: Yes.

MR. STROUD: First of all, Your Honor, I would like to address the first point. First, I would like to start with the part that Mr. DeGraffenreidt just ended up on, we are talking about a mere 2.2 percent increase, which increases telephone service throughout the state by a penny, under a bond that is refunded if the company is wrong. The other point I would like to point out with respect to the paying of rates, it would be our belief based upon the defendants' order in our last general rate proceeding that it has expressed a preference for across the board treatment and the Court could issue an injunction today to that effect.

THE COURT: Do what now?

MR. STROUD: Express the preference, Your Honor, (38) for an across the board rate increase in our last general rate increase.

THE COURT: You did that?

MR. STROUD: When we went in before the Commissioner.

THE COURT: What do you say about that, Mr. DeGraffenreidt?

MR. EMGE: I will have to speak too because the Commission did not unequivocally express a preference, they increased certain rates and others weren't increased.

THE COURT: We are stuck anyway we look at it.

MR. EMGE: And, Your Honor, it also was predicated the rate consideration is also interwoven with considerations of what the revenue requirement is.

THE COURT: I know that. I am trying to be amusing.

(Laughter.)

MR. STROUD: If we weren't suffering $44,000 a day harm, Your Honor, it would be. But I would like to just refer the Court if I could to the order issued for the defendants.

THE COURT: Well, I am not going to bleed for you, I can tell you that.

MR. STROUD: But I would like to refer the Court to pages 75 and 76 of the Commission's order and I think (39) therein is the discussion of this across the board rate increase.

THE COURT: What can I do about that?

MR. STROUD: The point I was making, Your Honor, is simply this, to address this irreparable harm quickly the Court could today direct the defendants to implement the 2.2 percent increase spreading that increase across the board in the same fashion that the Commission ordered at the conclusion of our last general rate case.

THE COURT: Why can't I more or less treat it in the same way that the District Court did in the state of Washington.

MR. STROUD: The reason I would suggest different treatment, Your Honor, first of all, they have just concluded a whole review of this question, how the rate

should be spread and they expressed this preference for an across the board treatment.

THE COURT: What do you have to say about that? Did you all come to an agreement on that?

MR. EMGE: Any increase in magnitude there has to be some determination what the revenue requirement effect is of following the FCC's order and I don't know with all due respect the Court has the expertise to determine that.

THE COURT: It certainly doesn't, I will be the first to admit it.

(40) MR. EMGE: The Court in Washington State clearly recognized that there was no time and they make a large point about this, there was no time contraints in the statute with respect to consideration for rehearing in Washington State either and the court still issued a decision.

MR. STROUD: Your Honor, if I might address that point, we are sort of hopping up and down, we are trying to follow the discussion. Perhaps the way out of this would be for the Court to direct the defendants to consider these depreciation requirements, direct the Commission to consider these depreciation requirements within some specified period of time, for example, ten days from the date of this Court's order for same. But we would request that the Court order the 2.2 percent increase today under bond with an instruction to the defendants that within 10 days they consider what impact, if any, this should have on the rate.

THE COURT: That makes sense.

MR. EMGE: Your Honor, that 2.2 percent rate increase would involve changing the rates in the state for a ten-day period and that seems to be totally unreasonable. The Commissioners will be unsure what the rates are — we had one rate change a month and a half ago and ten days from now another rate change.

THE COURT: But you did that on your own.

MR. EMGE: Your Honor, the company waited five (41) weeks after the Commission's decision to seek intervention, and it seems to me that they cannot argue we need ten more days, they waited five weeks.

MR. STROUD: Your Honor, I have to respond. First let me respond to the five weeks point. We did ask the Commission to allow us to put these rates in under bond. At the time we were filing our reconsideration requests there was no doubt in our mind that a sister Bell Company in Washington state was going down this road that we are going down today and certainly we didn't want to come in here without having the benefit from the Washington Court. Quite honestly, we waited for that decision. The point is, while we were waiting we were giving this Commission every possible opportunity to allow us to put these rates in subject to refunding and under bond; they have not yet done that. So the question of how long we waited is not really a relevant one, but if the Court wants to know our rationale, that is it. We were waiting for the precedence and we had to put the case together.

Now, if you look at the Seattle case, that case was decided on March 10th, we filed our case on March 21st. By the time we got the papers and the pleadings, found out what the issues were out there, we came into this Court as quickly as we could.

THE COURT: Well, I think because of the urgency (42) of the situation I have got to do something today and I will do it today. But in reference to a more learned let's say and careful opinion, I will probably get something out within a week, but I can give you some general lines here that I may be able to help you and let's see if you people can't get together and fashion an injunction which would be agreeable to both of you.

After considering the written submissions of the parties and the intervenor and having heard the oral arguments

today, I have come to the conclusion that an injunction should issue and I will render an opinion which I will get out, and be more careful in my language, and also as to the reasons for it, within about a week. I think that is all right with everybody concerned I assume.

MR. STROUD: Yes, sir.

MR. EMGE: Yes.

THE COURT: And anything I say here, of course, is subject to that opinion and the changes in that opinion and the facts and as to the law and the rest of it concerned, and of course to the editing of what I am about to say here today. I would change all that in the opinion but in reference to the conclusion I come to I will not change that.

I find that the plaintiff is entitled to relief requested and it is clear that the plaintiff will suffer an irreparable harm in the absence of the injunction requested (43) because the PSC is without power to order retroactive recovery of money and that the balance of harm is in the C&P's favor. This decision will not substantially harm other parties the Court feels because the provisions will be made for reimbursement by the C&P to these customers in the event the FCC erred in adopting its new depreciation standards and, of course, we will all track the Virginia case in the Fourth Circuit in that connection and wait for that result.

Insofar as the public interest is concerned we have an interest in this case as residents of Maryland and as residents of the United States who are entitled to some nationwide uniformity in the telecommunications field. That is congressional policy and this Court will abide by it. Therefore, no interest is overriding as the public interest and the mutual interest the public shares cannot be bifurcated under these circumstances. I think that that is the rule generally followed in the situation where there

is dual control over the matter like there is in this particular instance.

Finally, of course, I believe that there will be the likelihood of success by the C&P at the Fourth Circuit level. I am persuaded that the Washington case is more in line with the thinking of the courts in connection with this matter and is certainly a matter that the federal courts have cognizance of as I have expressed already above. (44) Nevertheless, I will not go so far as to accept on its face the C&P's conclusion that the rate they are entitled to is 2.2 percent. This decision will be left to the Public Service Commission.

Therefore, this whole situation will be turned back to the Public Service Commission and by order of this Court the Public Service Commission will and is hereby ordered to abide by the mandate of the FCC for these depreciation structures and the PSC will be given ten days to work this out with the plaintiff and establish a structure by compliance with the FCC. Additionally, the parties are instructed to establish a rebate structure which can be utilized in the future, if necessary, which will return to the consumers all excess monies paid into the system with interest. In the event the Fourth Circuit later determines these monies were not due and the FCC was in error, provision should also be made for those who terminate their services in the interim so that they may get the rebate either automatically or by application to the C&P.

I would like you to get together, therefore, and draw the proper injunction with the proper words in it as you know with reference to irreparable harm and other things that are necessary in conformity with the Blackwelder decision and I will sign it. Okay?

MR. EMGE: Thank you, Your Honor.

(45) THE COURT: All right, gentlemen. Thank you.

(Adjourned at 12:00 o'clock noon.)

(46) CERTIFICATE

I, Paul M. Mackaro, Official Reporter for the United States District Court for the District of Maryland, appointed pursuant to the provisions of Title 28, United States Code, Section 753, do hereby certify that the foregoing is a true and accurate transcript of the proceedings made in the aforementioned and numbered case on the date hereinbefore set forth, and I do further certify that the foregoing transcript has been prepared by me or under my supervision.

Paul M. Mackaro,
Official Reporter.